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DUAL DISTRIBUTION AND ANTITRUST LAW

Robert Zwirb*

I. INTRODUCTION

Manufacturers and suppliers have two obvious choices for distributing their goods. They can either vertically integrate and distribute directly to final customers or they can distribute indirectly through independent distributors.¹ A third and less obvious choice is for the manufacturer to distribute both directly and through independent dis-

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1. The topic of this Article centers on one specific form of distribution referred to as dual distribution. It is important, however, to understand other types of distribution and the economic relationships that can form between suppliers and distributors.

Economic activity occurs at different levels or stages of a "chain of distribution" with manufacturers at one end and consumers at the opposite end of the chain. Although the borders between these levels—or the point where a firm is located on the chain of distribution—are not always clear, the level at which economic activity occurs is often used as a reference point to define legal relationships in antitrust law. For example, *horizontal* arrangements are those among firms at the same level of the chain—e.g., different manufacturers—while *vertical* arrangements are those among firms operating at different levels of the chain—e.g., a manufacturer and his distributors. See *United States v. Topco Assocs., Inc.*, 405 U.S. 596, 608 (1972). Under this reasoning, an agreement between two distributors of a product is horizontal, while an agreement between a manufacturer and a distributor is vertical. Antitrust law is especially concerned with horizontal arrangements because firms located on the same market level are considered to be direct competitors.

Vertical integration occurs when a firm covers more than one stage in the chain of manufacturing and distribution. Complete vertical integration occurs when the entire chain is covered. See, e.g., F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 78 (2d ed. 1980); Adelman, *Integration and Antitrust Policy*, 63 HARV. L. REV. 27 (1949). Such integration usually occurs when a firm takes on a function that an independent firm had previously supplied or performed. Vertical integration can occur either backward—e.g., a distributor takes over the production role—or forward—e.g., a manufacturer takes over the distribution function. A vertically integrated firm does its own production and distribution. A non-integrated manufacturing firm, however, must hire independent firms, referred to as "independent distributors," to distribute its product. Dual distribution is a form of partial vertical integration. It comes into play when a firm performs *some* of the distribution functions itself, while retaining independent firms to perform the rest.

Some courts view the relationship between supplier and its independent distributors in a dual distribution arrangement as horizontal since they function at the same market level when distributing. As we will see *infra* text accompanying notes 65-106 and 109-23, however, this view is a formalistic way of perceiving these relationships, which does not always correspond

tributors at the same time. This latter choice is really a mixture of the first two and is referred to as "dual distribution."² Despite expressions of doubt by some courts, vertical integration is generally regarded as a legal method of distribution, equivalent to an inherent right of the manufacturer.³ As for the employment of independent distributors, if such em-

to economic realities. These relationships, nevertheless, are legally very significant since anti-trust law treats most horizontal arrangements much more harshly than vertical ones.

Throughout this Article "manufacturer" will be used interchangeably with "producer" and "supplier." "Distributor" will be used interchangeably with "dealer," "reseller" or "retailer."

2. Numerous efficiency-related reasons why manufacturers might adopt a dual distribution system exist. For example, it might be more efficient for the manufacturer to sell directly to some, but not all, final customers in order to handle large orders or to service large buyers. Dual distribution is sometimes motivated by a manufacturer's desire to protect its reputation, by preventing distributors from engaging in opportunistic behavior. Dual distribution also permits manufacturers to more easily monitor their distribution systems and to provide competitive stimulus to independent distributors. Critics allege, however, that dual distribution may be imposed for non-efficiency reasons: to facilitate price squeezes on independent dealers and to implement price discrimination. See Schwartz & Eisenstadt, *Vertical Restraints*, U.S. Dept. of Justice Antitrust Div., Econ. Policy Office Discussion Paper, at 65-71 (Dec. 2, 1982) for a summary of the economic rationales for dual distribution.

3. In *United States v. Columbia Steel Co.*, 334 U.S. 495, 525 (1948), the Supreme Court stated: "It seems clear to us that vertical integration, as such without more, cannot be held violative of the Sherman Act." In *United States v. Paramount Pictures*, 334 U.S. 131, 173-75 (1948) the Court also rejected the Department of Justice's argument that vertical integration was illegal per se. Recently both the Fifth and Seventh Circuits reaffirmed the legality of vertical integration. In *University Life Ins. Co. of America v. Unimarc Ltd.*, 699 F.2d 846, 852 (7th Cir. 1983), the court noted: "Firms constantly face 'make-or-buy' decisions—that is, decisions whether to purchase a good or service in the market or to produce it internally—and ordinarily the decision, whichever way it goes, raises no antitrust question." In *Jack Walters & Sons Corp. v. Morton Bldg., Inc.*, 737 F.2d 698, 710 (7th Cir.), *cert. denied*, 469 U.S. 1018 (1984), Judge Posner commented:

[V]ertical integration is not an unlawful or even a suspect category under the anti-trust laws Vertical integration is a universal feature of economic life and it would be absurd to make it a suspect category under the antitrust laws just because it may hurt suppliers of the service that has been brought within the firm.

Besides being legal, Posner also noted that "vertical integration is usually procompetitive." *Id.* See also *Red Diamond Supply Inc. v. Liquid Carbonic Corp.*, 637 F.2d 1001, 1006-07 (5th Cir.), *cert. denied*, 454 U.S. 827 (1981); *Associated Radio Serv. Co. v. Page Airways, Inc.*, 624 F.2d 1342, 1351 (5th Cir.), *cert. denied*, 450 U.S. 1030 (1980).

While vertical integration, as a method of distribution, is legal, the process by which firms become vertically integrated (e.g., through acquisitions) may be viewed differently. See, e.g., *Jack Walters & Sons*, 737 F.2d at 710 (while vertical integration is lawful and usually procompetitive, if a firm integrates "in an unlawful fashion it would not be immune from liability just because it had an unexceptionable end in view"). See also the district court opinion in that case, 1983-1 Trade Cas. (CCH) ¶ 65,284 (E.D. Wis. 1983), *aff'd*, 737 F.2d 698 (7th Cir.), *cert. denied*, 469 U.S. 1018 (1984), where the court indicated that vertical integration could in certain circumstances be illegal: "a scheme to force independent dealers out of business pursuant to a plan of vertical integration may be a violation of Section 1 of the Sherman Act." *Id.* at 69,682. Courts will also examine the purpose and effects of such integration. *United States v. Paramount Pictures*, 334 U.S. at 174. See also *Martin B. Glauser Dodge Co. v. Chrysler*

ployment is accompanied by nonprice restrictions on the freedom of independent distributors to distribute the manufacturer's goods, then legality is less clear and is usually determined by the rule of reason.⁴ The use of the third or blended form of distribution, however, raises a number of legal problems which courts have, as yet, grappled with unsuccessfully.⁵ From an antitrust perspective, dual distribution is a perplexing practice that is not easily understood.

Firms that engage in dual distribution come under antitrust scrutiny because, by definition, they compete at two different levels in the distribution chain. At the production level, the dual distributor competes with

Corp., 570 F.2d 72, 83-84 (3d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978); *In Re Coca-Cola Co.*, 91 F.T.C. 517, 613 n.14 (1978), *rev'd*, 642 F.2d 1387 (1981). See also U.S. Dept. of Justice, Merger Guidelines, § 4.221 at 47 (1984), 49 Fed. Reg. 26,823, 26,836 (1984) ("A high level of vertical integration by upstream firms into the associated retail market may facilitate collusion in the upstream market by making it easier to monitor price.").

The economic literature generally agrees with the view that vertical integration should raise no antitrust concern. P. AREEDA & D. TURNER, *ANTITRUST LAW* § 724 (1978) note that in the absence of market power, "vertical integration lacks antitrust significance. It is either competitively neutral or affirmatively desirable because it promotes efficiency." See also R. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 227 (1978) [hereinafter *ANTITRUST PARADOX*]; Adelman, *supra* note 1; Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157 (1954) [hereinafter *Vertical Integration*]; McGee & Basset, *Vertical Integration Revisited*, 19 J. L. & ECON. 17 (1976). Some critics contend that vertically integrated firms can injure nonintegrated competitors by exerting either a "price squeeze" or a supply squeeze on the latter that lowers the latter's revenues or raises their costs. See BAIN, *INDUSTRIAL ORGANIZATION* 360-62 (2d ed. 1968) (although noting that such behavior may simply reflect normal and prudent pursuit of advantages inherent in integration); Comanor, *Vertical Mergers, Market Power, and the Antitrust Laws*, 57 AM. ECON. REV. 254 (1967); Krattenmaker & Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209 (1986); SALOP & SCHEFFMAN, *Raising Rivals' Cost*, 73 AM. ECON. REV. 267 (1983). But other economists vigorously dispute these views. See S. OPPENHEIM, G. WESTON & J. MCCARTHY, *FEDERAL ANTITRUST LAWS* 356-59 (4th ed. 1981) [hereinafter *FEDERAL ANTITRUST LAWS*] for a summary of the critique of the price and supply squeeze theories as well as criticism of the view that vertical integration facilitates predatory conduct in general.

See also *ANTITRUST PARADOX*, *supra*, at 156-59 on the issue of whether a firm's choice of distribution patterns imposes costs on rivals. Bork acknowledges that certain distribution patterns and restrictions can raise rivals' costs, but argues that they often represent the optimal or most efficient pattern or practice. See also Hovenkamp, *Antitrust Policy, Restricted Distribution, and the Market for Exclusionary Rights*, 71 MINN. L. REV. 1293, 1304-05, 1309-12, 1315 (1987) (cautions against inferring that cost raising strategies are anticompetitive since they can also increase efficiency).

4. *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 57-59 (1977). See *infra* note 12 for an explanation of the rule of reason standard.

5. This Article will deal primarily with how the courts have treated antitrust matters involving dual distribution arrangements. The major theme of this Article is that the legal approach courts use does not sufficiently take into account the economic effects of such arrangements.

other manufacturers of the generic product.⁶ At the distribution level, the dual distributor competes with independent distributors of its own brand.⁷ This latter form of competition has raised antitrust concerns over the years.⁸

The problem dual distribution presents to antitrust authorities is analytical. How to treat such arrangements, even how to characterize them, has been a matter of substantial debate among scholars⁹ and courts¹⁰ for a number of years.

How dual distribution is perceived is important. Because company-owned and independent distributors operate at the same functional level, they have been considered to be "horizontal" competitors. Distribution restrictions imposed by manufacturers involved in dual distribution have

6. Note, *Antitrust Treatment of Intrabrand Territorial Restraints Within a Dual Distributional System*, 56 TEX. L. REV. 1486, 1489 (1978). Such "competition" is known as "inter-brand" competition. The Supreme Court has stated that this form of competition—"the competition between manufacturers of the same generic product"—is the primary concern of antitrust law. *Sylvania*, 433 U.S. at 52 n.19.

7. Note, *supra* note 6, at 1489. This form of "competition" is often referred to as "intra-brand" competition since it involves competing sellers of the same brand of the generic product.

8. Although case law and literature characterize the relationship between a manufacturer and its independent distributors as "competitive" in nature, such a characterization is questionable, especially where the parties are acting jointly to maximize their profits. The interests of competitors are usually antagonistic. But this proposition is not true between a supplier and its resellers where they are acting jointly to maximize interbrand sales and profits. In such circumstances, their interests are identical.

The above conclusion does not imply that *all* their interests are *always* identical. While manufacturers and distributors are not rivals, their relationship is prone to problems common in principal/agent relationships. The action of one party in the relationship can affect the other's profits. Sufficient incentive incompatibilities exist between manufacturers, distributors and retailers such that they will not necessarily work smoothly toward maximizing the full stream profit. Indeed, vertical restraints exist, in part, to minimize these incentive incompatibilities. See Caves, *Vertical Restraints in Manufacturer-Distributor Relations: Incidence and Economic Effects*, in ANTITRUST & REGULATION 29 (Grieson ed. 1986); Rey & Tirole, *The Logic of Vertical Restraints*, 76 AM. ECON. REV. 921 (1986); Rey & Tirole, *Vertical Restraints from a Principal-Agent Viewpoint*, MARKETING CHANNELS, RELATIONSHIP AND PERFORMANCE 3 (L. Pellegrini & S. Reddy ed. 1986).

The law's automatic assumption that the interests of the suppliers and its resellers in a dual distribution setting are *always* antagonistic is therefore wrong. Despite dual and independent distributors' mutual interests, this Article will continue to use legal literature and case law's characterization of their relationship as one that is competitive.

9. Altschuler, *Sylvania, Vertical Restraints, and Dual Distribution*, 25 ANTITRUST BULL. 1 (1980); Baker, *Interconnected Problems of Doctrine and Economics in the Section One Labyrinth: Is Sylvania A Way Out?*, 67 VA. L. REV. 1457, 1509-15 (1981); Liebler, *Intrabrand "Cartels" Under GTE Sylvania*, 30 UCLA L. REV. 1, 49-50 (1982) [hereinafter *Intrabrand Cartels*]; Note, *supra* note 6.

10. See, e.g., *infra* text accompanying notes 73-106. Compare *American Motor Inns, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230 (3d Cir. 1975) with *Red Diamond*, 637 F.2d 1001.

likewise been treated as "horizontal" and, therefore, illegal per se under the Sherman Act.¹¹ Yet the same restrictions imposed by a manufacturer not involved in dual distribution are treated as "vertical" and subject to the less harsh "rule of reason" analysis.¹² Thus, manufacturers who compete with their independent distributors for customers further down the line of distribution are treated differently from manufacturers who rely exclusively on independent distributors or manufacturers who are completely vertically integrated.

This Article will discuss dual distribution as a method of competition, focusing on how this distribution pattern interacts with both the manufacturer's pricing policy and the restrictions the manufacturer im-

11. Section 1 of the Sherman Antitrust Act prohibits "[e]very contract, combination . . . , or conspiracy in restraint of trade or commerce" 15 U.S.C. § 1 (1982). An arrangement or practice that is illegal per se is one that is conclusively presumed to be anticompetitive as well as one that lacks any efficiency creating effects. The Supreme Court described the rule of per se illegality in the following famous passage.

[T]here are certain agreements or practices which because of their *pernicious effect on competition* and *lack of any redeeming virtue* are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.

Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958) (emphasis added).

12. One court has noted an "emerging tendency" of courts to view dual distribution arrangements as vertical and, thus, subject to rule of reason analysis where distribution restrictions do not lessen interbrand competition or restrict output. *See* *Midwestern Waffles, Inc. v. Waffle House, Inc.*, 734 F.2d 705, 720 (11th Cir. 1984). Under the rule of reason, the plaintiff must *prove* that the challenged practice or arrangement is anticompetitive. The practice undergoes a more comprehensive evaluation called the rule of reason balancing inquiry. In the balancing inquiry, the purported purpose or justification is taken into account. Justice Brandeis articulated the rule of reason standard in a passage better known for its breadth than for its precision.

The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences.

Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

More recently, the Supreme Court articulated a standard that distinguished between these two rules—i.e., rule of reason versus per se rule—in terms that are economically relevant. The Court stated:

[O]ur inquiry must focus on . . . whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output . . . or instead one designed to "increase economic efficiency and render markets more, rather than less, competitive."

Broadcast Music, Inc. v. Columbia Broadcasting Sys., 441 U.S. 1, 19-20 (1979) (quoting *United States v. United States Gypsum Co.*, 438 U.S. 422, 441 n.16 (1978)).

poses upon its distributors. This Article will then explore the antitrust implications raised by competition between manufacturer-owned and independently-owned distributors.

Section II of this Article will look at dual distribution in its generic sense and will describe how the law treats this arrangement. While dual distribution generates little concern by itself, problems arise if these arrangements are combined with nonprice restraints on competing independent distributors. Since the law of dual distribution is closely related to the law of vertical nonprice restraints, section III will describe the process courts undertake to determine the proper legal standard in matters involving nonprice restraints. This section will then briefly summarize the relevant case law.

A survey of the leading cases that constitute an evolving law of dual distribution will follow. The cases are divided, on a rough scale, into those cases where the courts view the restrictions imposed by dual distributors as constituting "horizontal" arrangements, discussed in section IV, and those regarded as "vertical," discussed in section V. These sections will also describe the conflict in case law between a formalistic approach to the law of dual distribution and one that analyzes such arrangements by their potential economic effects. As will be seen, the conflict is endemic to both horizontal and vertical cases. The vertical cases described in section V combine elements of both approaches. However, a trend is slowly evolving towards incorporating economic analysis. The survey of cases in section V is arranged in a manner to reflect this slow evolution.

Section VI highlights three opinions that depart most vividly from the usual formalistic approach in favor of one that relies heavily upon economic analysis. Two of these opinions are dissenting ones. Section VII formulates a framework based on economic factors that can be applied in dual distribution cases. Finally, section VIII concludes with a critique of the legal approach that has prevailed despite the recent inroads of the economic alternative.

II. DUAL DISTRIBUTION AS A LEGAL ARRANGEMENT

Few cases have ruled on the issue of whether dual distribution—a distribution arrangement whereby a manufacturer is said to compete with its independent distributors—is, by itself, legal under the antitrust laws. In the usual case, dual distribution arises in connection with some other activity in which the manufacturer has engaged—e.g., the imposition of territorial or customer restrictions on its distributors or subsidization of company-owned distributors. Thus, the representative dual

distribution case entails a combination of simple dual distribution and additional vertical restraints on competition. The existence of dual distribution, as will be seen, usually colors the court's view of the ancillary practice in question.

When considered by itself, courts have found the practice of dual distribution to be legal. For example, in *Rea v. Ford Motor Co.*,¹³ an automobile manufacturer operated both factory-owned retail stores and "dealer development stores," and thus competed with its independent dealers. The *Rea* court stated: "We have no doubt that there is nothing inherently evil in a dual distribution system whereby a manufacturer may sell its own products to the customers directly through company outlets along side [sic] independent dealers."¹⁴

The Tenth Circuit expressed a similar view with regard to a manufacturer's practice of selling laminates and adhesives directly to large accounts. The Tenth Circuit stated that the manufacturer's practice of "selling directly to certain large accounts reflects a dual distribution system that standing alone, is perfectly lawful"¹⁵

Courts not only tolerate wide discretion in a seller's choice of a distribution system, but also in the modification of that system after it is established, even if some intrabrand competitors are harmed. As the District Court for the District of Columbia noted: "A seller does not commit himself irrevocably to one method of distribution once commenced, and he may terminate, modify, and change his distribution system so long as his arrangements are legal. The agency system is a lawful and well-accepted means of distribution."¹⁶

Distribution by the manufacturer comes under closer scrutiny, how-

13. 355 F. Supp. 842 (W.D. Pa. 1972), *vacated*, 497 F.2d 577 (3d Cir. 1974).

14. *Id.* at 865.

15. *Dart Industries v. Plunkett Co.*, 704 F.2d 496, 499 (10th Cir. 1983). *But see* Pitofsky, *The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restrictions*, 78 COLUM. L. REV. 1, 28, 31-32 (1978) (arguing that a manufacturer's retention of a class of customers should be per se illegal).

16. *Newberry v. Washington Post Co.*, 438 F. Supp. 470, 484 (D.D.C. 1977). In *In re Coca-Cola Co.*, the Federal Trade Commission commented:

It should be noted that soft drink syrup producers . . . may be able to enter new markets nationwide . . . by offering exclusive trademark licenses of limited duration to existing bottlers or by encouraging new bottlers into the market. If the search for independent capital is unsuccessful or if an independent bottler decides to withdraw from the market, a syrup company may then decide to integrate vertically in order to preserve its market position. Should it, in fact, integrate under these circumstances, it would, of course, be entering the "bottling level," but we do not read *Topco* as condemning this type of dual distribution program as a horizontal market allocation arrangement.

91 F.T.C. 517, 613 n.14 (1978), *rev'd*, 642 F.2d 1387 (D.C. Cir. 1981) (emphasis added). See *infra* note 116. This approval of vertical integration, however, is unduly narrow. The commis-

ever, when the issue of predation is also involved. That issue most frequently arises in cases involving the relationship between automobile manufacturers and their dealers.¹⁷ No case has sustained a judgment against an automobile manufacturer for operating its own dealerships. However, some cases have recognized the possibility that in certain circumstances, such as where the manufacturer's dealers were also engaged in predatory pricing, an independent automobile dealer could recover for the injury to its business caused by competition from a factory dealership.¹⁸ One court described the state of the law regarding manufacturer predation in the context of dual distribution as follows: "It is true that practices which are not unlawful in isolation may, when combined with a predatory purpose, constitute an illegal restraint of trade."¹⁹

Independent dealers have also claimed that factory dealerships are subsidized, permitting them to drive the independents out of business. However, mere subsidies from the manufacturer to the factory dealer for the purpose of increasing market penetration are not illegal. As the Third Circuit has pointed out, subsidizing a dealer has no different competitive effect than if the dealer obtains more favorable financing from a bank or venture capital investment firm.²⁰ Still, most courts find the issue of "manufacturer predation" troubling, especially when it arises in dual distribution litigation. While the manufacturer is free to contractually end its business relationship with independent dealers directly, it apparently cannot do so indirectly through price competition.²¹

sion's statement implies that such integration may not be reasonable under more general circumstances. Such an implication is not sound on economic grounds. See *supra* note 3.

17. Independent automobile dealers have brought numerous actions against their suppliers, domestic automobile manufacturers, for operating or financing factory dealerships in direct competition with them. The manufacturer's right to do so, however, has withstood these challenges. Thus, in a challenge to the American Motors Corp. (AMC) the court stated that it "cannot conclude that [AMC's] lawful decision to place a competing dealership in the area runs afoul of the antitrust laws since 'the purpose of the Sherman Act is to protect competition, not competitors.'" *Speed Auto Sales, Inc. v. American Motors Corp.*, 477 F. Supp. 1193, 1196 (E.D.N.Y. 1979) (citations omitted).

18. See *Coleman Motor Co. v. Chrysler Corp.*, 525 F.2d 1338 (3d Cir. 1975); *England v. Chrysler Corp.*, 493 F.2d 269 (9th Cir.), *cert. denied*, 419 U.S. 869 (1974); *Mount Lebanon Motors, Inc. v. Chrysler Corp.*, 283 F. Supp. 453 (W.D. Pa. 1968).

19. *Jack Walters & Sons Corp. v. Morton Bldgs., Inc.*, 1983-1 Trade Cas. (CCH) ¶ 65,284, at 69,682 (E.D. Wis. 1983), *aff'd*, 737 F.2d 698 (7th Cir.), *cert. denied*, 469 U.S. 1018 (1984).

20. *Martin B. Glauser Dodge Co. v. Chrysler Corp.*, 570 F.2d 72, 85-86 (3d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

21. See *Rea*, 355 F. Supp. 842, where Ford Motor Co. subsidized its subsidiary dealership losses. The district court reasoned:

The evidence here shows that Ford Motor Company, the defendant, is the only source of Ford and Lincoln-Mercury automobiles, trucks and other automotive products. An independent Ford Dealer has a large investment in money and goodwill tied up in Ford vehicles and facilities for them. Under the terms of the sales

In contrast to the pure dual distribution case, or to the dual distribution case involving predation, most of the litigated cases involve both dual distribution and the use of various ancillary vertical constraints. Some courts have ruled that the existence of dual distribution does not change the way ancillary vertical practices should be viewed. The Fifth Circuit, for example, in ruling that a manufacturer's imposition of territorial and customer restrictions upon its distributors was not illegal per se, stated: "[t]hat [the manufacturer] also distributed some of its own goods does not alter the situation."²² In another case,²³ the plaintiff challenged restraints a manufacturer had imposed on its district managers. While the court rejected the plaintiff's characterization of the relationship as one of dual distribution, it also noted, "the import of such a finding of competition would not be significant."²⁴

Most courts, however, react skeptically to *restraints* dual distributors impose on competing independent distributors.²⁵ At the very least, they evaluate behavior by such firms with greater scrutiny. This occurs even in cases holding that the rule of reason governs such restraints. For example, the Fifth Circuit in *Abadir & Co. v. First Mississippi Corp.*,²⁶ stated: "[T]hose normal market factors encouraging a supplier to let its distributors compete are less effective to the extent that [the defendant-manufacturer] also competes as a distributor."²⁷

Such judicial caution towards restrictions accompanying dual distribution arrangements apparently is widespread. Thus, in *Graphic Prod-*

agreement, he must use his best efforts to achieve the full extent of Ford market penetration reasonably anticipated in his area. He cannot turn to another manufacturer for vehicles. If he is shut off, he strangles to death in a short time. Thus, if Ford for its own purpose chooses to use its company stores and dealer development agencies for the purpose of maximizing its profits through large subsidies to these company-owned facilities with the result that private dealers are put at a substantial economic disadvantage, it is the court's opinion that a cause of action is made out under Sherman 1.

Id. at 867. Of course, it is not in the interest of Ford to unduly "squeeze" or eliminate efficient distributorships. It is apparent, however, that the only concern of the courts in these cases is to preserve the viability of *all* existing independent dealerships without taking into account whether they are efficient.

22. *Abadir & Co. v. First Miss. Corp.*, 651 F.2d 422, 425 (5th Cir. 1981). *But cf.* *Krehl v. Baskin-Robbins Ice Cream Co.*, 78 F.R.D. 108 (C.D. Cal. 1978). In *Krehl*, the court implied that dual distribution changed the legal form of a franchisor's distribution arrangement: "If BRICO were the franchisor and nothing more, this system would indeed be vertical." *Id.* at 123.

23. *Laurence J. Gordon, Inc. v. Brandt, Inc.*, 554 F. Supp. 1144 (W.D. Wash. 1983).

24. *Id.* at 1152 (citations omitted).

25. *See infra* text accompanying notes 35-37.

26. 651 F.2d 422.

27. *Id.* at 427.

ucts Distributors, Inc. v. Itek Corp.,²⁸ a dual distributor's restraints were considered vertical and subject to evaluation under the rule of reason, yet the Eleventh Circuit warned: "Although we treat Itek's restraints as vertical, its motivation to restrict competition from its independent distributors is a factor in our analysis of its alleged pro-competitive purposes."²⁹

Other courts consider the context in which dual distribution occurs in assessing its legality. For example, in *Rea v. Ford Motor Co.*,³⁰ the court stated: "Whether dual distribution is or is not illegal or evil in and of itself, it does become an antitrust problem in the context of its use by a company possessing substantial market power."³¹

Some courts are even more harsh. In *Interphoto Corp. v. Minolta Corp.*,³² the court suggested that dual distribution has a synergistic—and by implication harmful—effect on vertical restrictions. "The Court notes, however, that proof of the existence of unlawful resale price maintenance, where the manufacturer is also a distributor . . . makes the anti-trust violation even more pernicious . . . for unlawful cartel activity then co-exists with the attempt to vertically control the discretion of the independent businessman."³³

And some courts, apparently mesmerized by the presence of dual distribution, carry out the synergy even further. As one court observed in 1979: "A number of lower courts have held . . . that the presence of dual distribution transforms intrabrand restrictions otherwise vertical in origin into horizontal ones."³⁴

Despite the fact that dual distribution *by itself* is considered legal, the harsh language cited above, reflects at best, an ambivalent attitude, and at worst, overt hostility toward such a system when it is accompanied by restrictions on competing intrabrand distributors. The belief that restrictions imposed by a manufacturer/distributor are motivated by an anticompetitive purpose underlies much of the litigation in this area.

28. 717 F.2d 1560 (11th Cir. 1983).

29. *Id.* at 1576 (footnote omitted). In fact, the court's implication that manufacturers have an incentive to restrict competition more severely at the distribution level when the manufacturer also distributes is wrong. The manufacturer's attitude toward restrictions on intrabrand competition should be the same no matter how its distribution network is arranged. See *Baker, supra* note 9, at 1510-11.

30. 355 F. Supp. 842.

31. *Id.* at 867. But see *Intrabrand Cartels, supra* note 9, at 3 n.11 and 26 n.78 (implies that market power is irrelevant in assessing the nature of an intrabrand restriction, since even a monopolist has no incentive to impose distribution restrictions that adversely affect efficiency and consumer welfare).

32. 295 F. Supp. 711 (S.D.N.Y.), *aff'd*, 417 F.2d 621 (2d Cir. 1969).

33. *Id.* at 718 n.2.

34. *Krehl*, 1979-2 Trade Cas. at 78,704.

III. DUAL DISTRIBUTION AND NONPRICE RESTRAINTS

When dual distribution is combined with restrictions on the freedom of independent distributors, problems from an antitrust perspective arise. This should not necessarily follow since if dual distribution by itself is legal and a practice ancillary to such a system is legal, the two together should be legal.³⁵ However, many courts do not accept this view and find illegality in instances where both dual distribution and the suspect vertical practice would be legal if standing alone.³⁶ This anomaly is seen as a legacy from cases that evaluated distribution arrangements by their "form" and generally viewed them as being "horizontal." Under the analysis adopted in such cases, the relationship of manufacturers with their distributors comes under greater scrutiny. As one commentator noted:

With the added element of dual distribution, however, a manufacturer enters into actual or potential competition with its independent distributors. For this reason, the same territorial or customer restrictions that were previously viewed as vertical may be reclassified as market allocations among competitors, or *horizontal* restraints of trade, which remain subject to rigid *per se* prohibition.³⁷

In most dual distribution cases, the controversy centers not upon the manufacturer's presence at the distribution level, but upon the manufacturer's imposition of restrictions upon independent distributors. In dual distribution cases, therefore, courts will look to the law of distributional restraints to determine whether the challenged restrictions accompanying such arrangements are legal. Under the guidelines the Supreme Court enunciated in *Continental T.V., Inc. v. GTE Sylvania, Inc.*,³⁸ a cru-

35. This is analogous to the Ancillary Restraints Doctrine Judge Taft developed in *United States v. Addyston Pipe & Steel Co.*, 85 F. 271 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899), where he proclaimed that restrictions "only ancillary to the main end" of a legitimate business union "were to be encouraged." *Id.* at 280.

36. See, e.g., *American Motor Inns, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230 (3d Cir. 1975).

37. Altschuler, *supra* note 9, at 2 (footnote omitted) (emphasis in original).

38. 433 U.S. 36 (1977). *Sylvania* involved a challenge to a manufacturer's distribution system in which the distributors—franchised retailers—were restricted to specific geographic areas. The challenge came from a former dealer who was terminated for violating these location restrictions. *Id.* at 38-40. Overruling *United States v. Schwinn & Co.*, 388 U.S. 365 (1967), the Court held that nonprice vertical restrictions such as the challenged location clause are governed by the rule of reason. *Id.* at 40, 59. However, the Court articulated two exceptions to its ruling: 1) where economic effects demonstrated that vertical restrictions deserve to be treated more stringently—"we do not foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibition under *Northern Pacific Railroad Co.* But we do make clear that departure from the rule-of-reason standard must be based upon demon-

cial issue is whether the distribution restrictions are vertical or horizontal. Under *Sylvania*, horizontal restraints are illegal per se,³⁹ while nonprice vertical restraints are governed by the rule of reason standard.⁴⁰

Sylvania, in effect, requires courts in dual distribution cases to characterize the restrictions at issue as either vertical or horizontal. At the same time, *Sylvania* emphasizes that the determination of legality of distributional restraints "must be based upon demonstrable economic effect rather than . . . upon formalistic line drawing."⁴¹ While *Sylvania* requires courts to rely upon economic analysis in deciding distribution issues, its distinction between "vertical" and "horizontal" restraints forces courts to engage in the very "formalistic line drawing" it purports to be eschewing.⁴² Nowhere is this more apparent than in the characterization analysis courts undertake in dual distribution cases.

A. The Characterization Process

1. The vertical-horizontal test

The "characterization process" is the term used to describe the analysis courts make in determining whether a challenged practice is to be governed by the per se or the rule of reason standard. The outcome of this process is important because under the per se standard, all debate regarding legality ends. If a practice is subject to the rule of reason, however, its legality will be litigated under that standard. Since *Sylvania*, the characterization process in dual distribution cases has focused almost exclusively on whether the distribution arrangement is vertical or horizontal.⁴³

The distinction between horizontal and vertical restraints, however, has not always been crucial in deciding the legality of nonprice restraints in dual distribution cases. Prior to 1967, nonprice vertical restraints

strable economic effect" *id.* at 58-59; and 2) where the challenged restrictions originated "in agreements among the retailers[.]" [t]here is no doubt that [such] restrictions . . . would be illegal *per se*" *Id.* at 58 n.28.

Ironically, *Sylvania* abandoned a dual distribution system in favor of a more traditional distribution system in order to increase market share. This illustrates that different distributional arrangements and restrictions are usually imposed or excised because of changing market considerations rather than for anticompetitive purposes. While *Sylvania* was not a dual distribution case, it greatly affected the outcome of such cases because it involved the same kind of restrictions imposed by dual distributors.

39. 433 U.S. at 58 n.28.

40. *Id.* at 57-59.

41. *Id.* at 59.

42. *Intrabrand Cartels*, *supra* note 9, at 2.

43. See 433 U.S. 36, 57-59 (1977).

were governed, as they are today, by the rule of reason.⁴⁴ But between 1967 and 1977, a dual distributor's vertical as well as horizontal restraints were regarded as illegal per se as a result of the Supreme Court's decision in *United States v. Arnold, Schwinn, & Co.*⁴⁵ In *Schwinn*, the Court held that while a dual distributor's nonprice restraints were *vertical*, they were nevertheless illegal per se.⁴⁶ Application of the per se approach to most distributional restraints was halted in 1977 when the Supreme Court decided the *Sylvania* case. In *Sylvania*, the Court reversed its holding in *Schwinn* and declared that nonprice vertical restraints were subject to the rule of reason standard.⁴⁷

Cases involving dual distribution today are initially analyzed on the basis of the court's perception as to whether the arrangement is horizontal or vertical rather than on an economic analysis of the arrangement.⁴⁸ The only difference between post-*Sylvania* cases and pre-*Sylvania* cases is that restrictions viewed as vertical are now analyzed under the rule of reason. Moreover, courts have shown a clear tendency to interpret dual distribution arrangements in post-*Sylvania* cases as vertical, whereas

44. It may be more accurate to say that prior to *United States v. Arnold, Schwinn, & Co.*, 388 U.S. 365 (1967), the courts upheld such arrangements. Posner argues that contrary to conventional wisdom, the rule of reason was rarely applied prior to *Schwinn* and, in fact, is "rarely used to decide [antitrust] cases." Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1, 14 (1977) [hereinafter *Rule of Reason*]. In any case, before 1961, nonprice *vertical* restraints were subject to the rule of reason, even where dual distribution was involved. In 1961, the Justice Department challenged territorial and customer restrictions imposed by White Motor Co., a truck manufacturer, that prohibited its dealers from reselling to certain large accounts reserved for itself. See *United States v. White Motor Co.*, 194 F. Supp. 562 (N.D. Oh. 1961), *rev'd*, 372 U.S. 253 (1963). However, in 1963, the Supreme Court rejected the Justice Department's challenge and refused to hold that White's vertical restrictions were subject to the per se rule established in horizontal market-division cases. *White Motor Co. v. United States*, 372 U.S. 253 (1963).

45. 388 U.S. 365.

46. *Id.* at 382. The per se standard governed vertical restraints where title passed from the supplier of the goods to the reseller. Only if the supplier retained ownership—such as in consignment sales—would such restrictions still be governed by the rule of reason standard. *Id.*

47. 433 U.S. at 57-59. In overruling *Schwinn*'s vertical per se rule, the *Sylvania* Court did not completely preclude application of a per se standard in appropriate cases involving vertical restraints. The Court stated: "[W]e do not foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibition . . ." *Id.* at 58.

48. Since *Sylvania*, the form of distributional restraints and, correspondingly, judicial perceptions of such forms, have taken on a greater importance than in the past. While the legal treatment of horizontal distributional restraints has remained the same—per se illegal—the changes in status pertaining to vertical restraints look like a ping pong game. Prior to *Schwinn* and following *Sylvania*, nonprice vertical restraints were generally regarded as lawful. In between those two decisions—for a period spanning a decade—vertical restraints on distributors were treated the same as horizontal ones, illegal per se. After *Sylvania*, such restraints were treated as illegal per se only if they were part of a "horizontal" arrangement, since *Sylvania*'s rule of reason approach applied only to *vertical* restraints.

before they were seen as horizontal.⁴⁹

While the change in results has been praised, the continued reliance by most courts on a mechanical classification framework has been criticized. The criticism is two-pronged. First, some argue that the horizontal-vertical analysis is irrelevant since dual distribution restrictions should never be considered "horizontal"; they are simply manufacturing arrangements.⁵⁰ Second, such an analysis is hardly an "economic" one, and any resulting "good" decisions are merely accidental.⁵¹

2. The source test

Recognizing that sole reliance on the vertical-horizontal distinction

49. A bizarre aspect of *Schwinn* and *Sylvania* is the impact those two decisions have had on the characterization process. Following *Schwinn*, most courts viewed distribution restraints imposed by dual distributors as horizontal. Nevertheless, their characterization had little practical significance since most vertical restraints were also illegal per se. After *Sylvania*, most courts shifted gears and decided that restrictions associated with dual distribution arrangements were "vertical" and thus governed by the rule of reason. Ironically, shifts in the prevailing legal standard for vertical nonprice restraints—per se versus rule of reason—also colored the way courts viewed the *form* of the restraints—vertical versus horizontal. One commentator summarized the abrupt changes in classification and legal status and the resulting confusion between issues of classification and those of legal standard as follows:

Thus, an interesting picture develops. Before *Schwinn*, when nonprice vertical restraints were subject to the rule of reason, courts refused (or neglected) to view dual distribution as triggering the per se rule applicable to horizontal restraints. Following *Schwinn*, courts consistently took precisely that position. Now, however, with *Sylvania*'s reinstatement of the rule of reason, courts are again refusing (or neglecting) to apply the horizontal approach, with a few notable exceptions. The majority of cases decided after *Sylvania* treat dual distribution restraints exclusively under the rule of reason.

Altschuler, *supra* note 9, at 84 (footnotes omitted).

50. Two economists in the Economic Policy Office of the Antitrust Division of the Department of Justice have criticized the view that restraints imposed by a dual distributor are horizontal or part of a collusive arrangement between the manufacturer's and independent dealerships.

To appreciate the flaw in this horizontal analogy, suppose first that the manufacturer was completely vertically integrated and imposed the same restraints as before on the company owned outlets. There would be no antitrust objection to these restraints in this case; certainly no horizontal aspect could be argued. Now suppose that the same restraints were imposed on independent dealers by a manufacturer who was entirely nonintegrated into distribution. The manufacturer would not impose the restraints solely to grant dealers supracompetitive profits, as would a dealer cartel, since he would prefer to collect those profits himself. Again, the motivation would be purely vertical—e.g., combating free riding among dealers. The situation is no different when, instead of being entirely nonintegrated or integrated, the manufacturer is engaged in dual distribution. The restraints on independent dealers should be viewed as imposed by the manufacturer qua manufacturer not qua dealer, destroying any parallel with a horizontal dealer conspiracy.

Schwartz & Eisenstadt, *supra* note 2, at 73-74.

51. See, e.g., Baker, *supra* note 9, at 1509-13; *Intrabrand Cartels*, *supra* note 9, at 49-50; Note, *supra* note 6, at 1490-91. See also *infra* text accompanying notes 65-67.

is unsatisfactory, some courts also look to the origin of any challenged distributional restriction.⁵² If the restriction originates from the manufacturer, the arrangement is deemed vertical and subject to the rule of reason. But if it is initiated by dealers or distributors acting in concert with themselves or with the manufacturer, a horizontal conspiracy or cartel is presumed, and the arrangement is deemed illegal per se.

While this test is somewhat of an improvement, it remains unsatisfactory.⁵³ The source test is based on the view that the restrictions a manufacturer imposes on its distributors are a manifestation of legitimate business judgment—a decision of little or no antitrust significance.⁵⁴ But a restraint originating from distributors is either one that is made among competitors or is one that makes the manufacturer an instrumentality of its distributors—either alternative of which has antitrust significance. That there should be any antitrust significance for the latter has been severely criticized for two principal reasons.

The first reason the source of a distributional restraint should not be determinative is the practical difficulty in determining where a given restriction originated. When the source is not apparent, courts will look to the possible motives and purposes behind the restraints. Most commentators, however, are skeptical of the legal system's ability to pinpoint true motives, and therefore of the ability to distinguish between dealer cartels

52. The landmark case which determined legality by focusing on the true source of a restraint was *United States v. General Motors Corp.*, 384 U.S. 127 (1966). See also *Abadir & Co. v. First Miss. Corp.*, 651 F.2d 422 (5th Cir. 1981); *Red Diamond Supply Inc. v. Liquid Carbonic Corp.*, 637 F.2d 1001 (5th Cir.), cert. denied, 454 U.S. 827 (1981); *H&B Equip. Co. v. International Harvester Co.*, 577 F.2d 239 (5th Cir. 1978); *Donald B. Rice Tire Co. v. Michelin Tire Corp.*, 483 F. Supp. 750 (D. Md. 1980).

53. It is an improvement because it at least does not question restrictions imposed by manufacturer/distributors on independent distributors. However, the source test condemns those restrictions originating from or initiated by dealers or distributors.

54. This viewpoint is not universally held. Professor Pitofsky, for example, argues that a per se rule should apply whenever a dual distributor "carves out an area or category of sale which it then retains exclusively for itself." Pitofsky, *supra* note 15, at 31. Alfred Dougherty, former Director of the FTC's Bureau of Competition stated that in such circumstances: "The manufacturer is in effect using the leverage created by the vertical relationship to insulate itself in its capacity as a retailer from the vigorous competition of other retailers." Dougherty, *Vertical Restraints: Recent FTC Initiatives* (remarks delivered at the National Antitrust Seminar of the National Association of Attorneys General) (Aug. 16, 1979), at 5-6 (cited in Altschuler, Sylvania, *Vertical Restraints, and Dual Distribution*, 25 ANTITRUST BULL. 1, 28 n.79 (1980)). These views, however, conflict with any reasonable analysis of the economics of vertical relationships including dual distribution. See *infra* text accompanying notes 235-38. If a manufacturer is free to distribute entirely by itself—i.e., to vertically integrate—it is not clear why partial self-distribution accompanied by intrabrand restrictions should raise antitrust concerns.

and restrictions that serve the manufacturer's interests.⁵⁵

The second reason courts should not blindly rely on source to determine legality is that even if it is possible to identify a restriction's origin, such an identification may mean little in economic terms. As Professor Liebeler commented: "The statement that someone 'imposed' something is not a meaningful statement in economic terms, and, in addition, is a poor way to determine whether an arrangement is horizontal or vertical. . . . A more relevant inquiry is whether an arrangement has the potential to restrict output."⁵⁶ Of course, a dealer-originated restriction may be anticompetitive, as well as efficiency enhancing.⁵⁷ The source test, however, simply assumes that restrictions originating from distributors are anticompetitive.⁵⁸

Reliance *solely* on the source test is especially dubious where the

55. See *Intrabrand Cartels*, *supra* note 9, at 24-30; and *Rule of Reason*, *supra* note 44, at 20.

56. Liebeler, Book Review, 66 CAL. L. REV. 1317, 1334 n.41 (1978) (reviewing R. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* (1978)).

57. As Liebeler explained:

Even if we were able to determine in a particular case that the restriction originated in joint action by the resellers, that would not dispose of the economic issue involved. For dealers, too, have an incentive to adopt, or urge their supplier to adopt, arrangements that increase the efficiency of the distribution system.

Intrabrand Cartels, *supra* note 9, at 10 (footnote omitted).

An example of such efficiency enhancing activity is where dealers band together and persuade their supplier to rid the distribution system of free riders. Liebeler argues that this is what was really going on in the *General Motors* case. *Id.* at 25.

The "free rider" problem occurs when consumers purchase products from discounters after receiving valuable information or pre-sale services from a full-service dealer. Both the discounter and the consumer in this situation are considered to be "free riders." Both benefit from the free services or information the full-service dealer provides. The free rider problem is an example of what economists call an externality. A manufacturer who desires to sell his product only when value-enhancing services are provided will take measures to prevent free riding by distributors and consumers. See *Sylvania*, 433 U.S. at 55. See also *Davis-Watkins Co. v. Service Merchandise*, 686 F.2d 1190, 1195 n.8 (6th Cir. 1982); Gerhart, *The Supreme Court and Antitrust Analysis: The (Near) Triumph of the Chicago School*, 1982 SUP. CT. REV. 319, 337-40; *Intrabrand Cartels*, *supra* note 9, at 1 n.4.

For a reseller cartel to be anticompetitive, the resellers must have market power over each supplier's product and the restrictions they impose must have no efficiency creating potential. Such activity really constitutes an *interbrand* dealer cartel as opposed to the more common *intrabrand* dealer cartel. See Liebeler, *1983 Economic Review of Antitrust Developments: The Distinction Between Price and Nonprice Distribution Restrictions*, 31 UCLA L. REV. 384, 405-06 (1983) [hereinafter *1983 Antitrust Developments*].

58. Because dealers have an incentive to increase the efficiency of their distribution system, it is wrong to assume that joint activity by dealers is always aimed at cartelization. See *Intrabrand Cartels*, *supra* note 9, at 22 n.67. This view is not universally shared. See position of FTC Commissioner Strenio (request, demand or threat by dealers must be most important contributing cause of a dealer termination for a finding of conspiracy to fix prices) in connection with proposed legislation regarding resale price-fixing as reported in *FTC Watch*, at 5 (Feb. 8, 1988).

distributors carry only one supplier's products. Some commentators contend that even when dealers collude or form a cartel and impose their will on the supplier, little reason to be concerned exists.⁵⁹ While such an intrabrand cartel would concern the supplier, its operation should not affect the final output to the market. Even in these conditions, the dealers have no incentive to restrict output or increase prices beyond that of the joint (supplier-distributor) profit maximizing level. These dealers cannot enhance the market power that their profit maximizing supplier already holds. While an intrabrand dealer cartel may affect the distribution of profits between dealers and the supplier, it should not affect output to consumers since both suppliers and dealers have a considerable interest in achieving a level of output that maximizes their *joint* profit level.⁶⁰

The idea that an intrabrand dealer cartel or intrabrand dealer collusion can impose no additional harm to consumers—in the form of output restriction or higher prices—is based on the theory of successive monopoly.⁶¹ This theory states that only one monopoly profit can be obtained

59. The Supreme Court in part supports this view. In *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 760-64 (1984), the Court held that a vertical price-fixing agreement between a manufacturer and its distributors cannot be inferred solely from the existence of complaints about a terminated distributor's prices from other distributors, or even from the fact that the termination came in response to complaints. On the other hand, evidence that the manufacturer and non-terminated distributors were not acting independently would support such a charge. This is consistent with the Court's holding in *Sylvania* that restrictions "originating in agreements among retailers" are illegal per se. *Sylvania*, 433 U.S. at 58 n.28. The second part of the Court's analysis is unsound, according to Liebel, because it does not take into account the efficiency-creating justification for joint dealer/manufacturer action: to rid the distribution system of a free riding dealer. See 1983 *Antitrust Developments*, *supra* note 57, at 408-13.

Bork cites two practical reasons why such cartels pose little concern: (1) cartelization among resellers is very difficult to maintain; and (2) is very easy for enforcement authorities to detect. THE ANTITRUST PARADOX, *supra* note 3, at 292-93. Also, the notion that dealers impose their will on the manufacturer should be viewed with more than the usual dose of skepticism, for it amounts to saying that manufacturers will take actions that are against their own interest. As Bork has aptly observed, a manufacturer "will not adopt marketing strategies that transfer money from his pocket to the pockets of his retailers." Bork, *Vertical Restraints: Schwinn Overruled*, 1977 SUP. CT. REV. 171, 188. See also Baker, *supra* note 9, at 1507-08.

60. As Professor Baker also explained:

A dominant cartel of dealers . . . presumably would recognize that its interest [in the efficient operation of the distribution system] is precisely the same [as the manufacturer's]. If, by virtue of overwhelming bargaining power, the dealers were able to take the lion's share of the overall profits from the sale of the product, leaving the manufacturer only the minimum competitive return on investment, they too would seek to enhance the interbrand competitiveness of the product and to hold costs to minimum.

Id. at 1490.

61. The theory of successive monopoly applies only to exclusive distribution arrangements

for a good.⁶² If a manufacturer is behaving like a monopolist, adding another monopolist at the distribution level will not increase monopoly profits. In other words, if a manufacturer is already extracting the maximum available profit, the formation of an intrabrand dealer cartel will not increase this profit. At best, an effective cartel acting to maximize profits could extract some of the monopoly profit away from the manufacturer. But this allocation of monopoly profits would have no bearing on consumers. Since neither manufacturers nor dealers have an incentive to restrict output or increase prices beyond the maximum profit level, manufacturers and dealers acting *jointly* should have no adverse impact upon consumers. Such joint action, at worst, can cause no more harm than a monopolist at the manufacturing level.⁶³

To summarize, if dealers, by colluding among themselves and with the manufacturer, can gain no more market power than the manufacturer already possesses, then the source of any challenged restrictions is not of great significance. Moreover, vertical restrictions, including those originating from the dealer level, may be imposed to enhance efficiency.⁶⁴ Finally, interbrand competition will constrain both manufacturers and dealers, even when acting jointly. The courts in dual distribution cases, however, completely miss these points when considering the source of a restriction.

where the output to the consumer is produced with fixed proportions of manufactured product and distribution services.

62. According to Oppenheim, Weston & McCarthy, "[a] common 'misconception' held by critics of vertical integration, 'is that the integrated concern earns 'double profits' from having two stages of its operations which gives it a competitive advantage.'" FEDERAL ANTI-TRUST LAWS, *supra* note 3, at 356. The theory of successive monopoly rejects the notion that such a firm can earn double profits. Instead, it can earn "merely a normal return on its investment in each market, the amount of which would be determined by competitive conditions in each market." *Id.* at 357 (footnote omitted). See also *Vertical Integration*, *supra* note 3, at 172 n.65, 195-97.

63. See *Intrabrand Cartels*, *supra* note 9 at 20-23, and 3 P. AREEDA & D. TURNER, ANTI-TRUST LAW § 725, at 200-08 (1978). Liebler does distinguish between reseller cartels involving the supplier and cartels not involving the supplier. The latter, he contends, "should continue to be illegal *per se*[]" because joint profit maximization is less probable where the supplier is not involved in the cartel. *Intrabrand Cartels*, *supra* note 9, at 5 n.18. If the manufacturer and its distributors do not act in concert, and instead attempt to attain the maximum profit independently, the overall combined profit will be reduced. Consumers will also suffer because output will be lower and prices will be higher. See *supra* text accompanying notes 60-63.

64. In *Sylvania*, the Supreme Court stated: "Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products." *Id.* at 54. See also *supra* notes 57 and 58.

B. The Enduring Legacy of Formalism

One commentator has described the process by which post-*Sylvania* courts characterize dual distributional restrictions as "a simplistic categorization analysis that focuses solely on the physical presence of a manufacturer on the distribution level in an intrabrand competitive capacity[.]"⁶⁵ Decisions that characterize arrangements on the basis of form or source can hardly be described as opinions based on "economic effect." While the "right" results may now be occurring, they are being arrived at for the wrong reasons. Application of the governing legal standard—per se or rule of reason—does not depend upon a distribution arrangement's potential economic effects, but upon the location of the manufacturer within that arrangement. The problem is that the distinction between horizontal and vertical arrangements is formalistic and divorced from economic realities. As Professor Liebler has commented:

The hope that the law of vertical restraints might be based on something other than formalistic line drawing, however, has gone largely unrealized in the five years since *Sylvania* was decided. No doubt this is due in part to the fact that many lawyers and judges are unfamiliar with or hostile to an economic approach to antitrust law. It is also due, however, to the fact that the *Sylvania* opinion itself was flawed by formalistic line-drawing. It was flawed to such a degree as to make inevitable the confusion that now afflicts the lower courts and most of the academic writing in this area of the law.⁶⁶

Additional reasons explain why *Sylvania* did not lead to a greater change in the way courts analyze dual distribution cases. Although *Sylvania* calls for an economic approach to deciding cases involving vertical restraints, it did not specify what such an approach entails. Moreover, *Sylvania*, in the words of one commentator, "created an enormous tension between itself and earlier cases that had been decided primarily on formalistic grounds."⁶⁷ This failure to explain the economic approach permits the traditional analysis to continue by default. *Sylvania*'s reliance on a horizontal-vertical distinction thus is hardly a significant departure from previous decisions based on formalistic grounds.

65. Note, *supra* note 6, at 1490.

66. *Intrabrand Cartels*, *supra* note 9, at 2. An example of a post-*Sylvania* case based on form rather than upon an analysis of economic effect is *In re Coca-Cola Co.*, 91 F.T.C. 517 (1978), *rev'd*, 642 F.2d 1387 (D.C. Cir. 1981), where the Federal Trade Commission stated that in light of *Sylvania*, "the first step in evaluating these restraints is to classify them as horizontal or vertical." *Id.* at 611.

67. 1983 *Antitrust Developments*, *supra* note 57, at 387.

It would, however, be misleading to state that *Sylvania* only altered the results, but not the underlying analysis in subsequent cases. While change has not been as dramatic as some commentators had hoped, the analysis applied in dual distribution cases has evolved slowly. Recent cases that apply the rule of reason analysis reflect a slight shift away from "formalistic line drawing" and have moved toward an analysis of the economic effects of distribution restraints. As will be seen in the following discussion, these cases combine elements of economic analysis while still clinging to vestiges of form.

Despite the inroads made by economic analysis in the post-*Sylvania* era, the crucial issue remains whether the suspect restraints are horizontal or vertical. A review of the cases indicates that characterization analyses are inconsistent. Moreover, the analyses are clouded because although most courts characterize the accompanying *restraints* on distribution, some courts characterize the entire distributional system. Alternatively, in some cases, the courts have examined the source of a challenged restraint—i.e., whether it originated from the manufacturer, in which case it is regarded as vertical, or the distributors, in which case it is regarded as horizontal.

We now turn to the cases analyzing dual distribution restraints, beginning with the ones that classify such restraints as horizontal and then proceeding to those that view them as vertical.

IV. HORIZONTAL CASES

A number of cases have characterized nonprice restraints imposed by dual distributors as horizontal. Almost all of these cases, however, were decided before *Sylvania*. Many of these cases spring from a Supreme Court decision regarding the legality of resale price restraints. That case, *United States v. McKesson & Robbins, Inc.*,⁶⁸ represents the only decision in which the Supreme Court addressed the question of whether a restraint associated with dual distribution is horizontal or vertical. McKesson manufactured its own line of drugs and, at the same time, was the largest drug wholesaler in the United States. It distributed its drugs directly to retailers and through independent wholesalers. McKesson also entered into "fair trade" agreements with wholesalers to fix the resale price of its drugs.

The case was decided under the Miller-Tydings and McGuire Acts, which exempted such agreements between manufacturers and distributors from the per se rule against vertical price fixing, but not those be-

68. 351 U.S. 305 (1956).

tween firms "in competition" with each other. The Court held that the agreements were horizontal because McKesson, as a dual distributor, competed "at the same functional level" with each of the wholesalers with whom it had agreements.⁶⁹ Therefore, the statutory exemptions of those Acts did not protect the agreements.

McKesson argued that its relationship with its independent distributors should be viewed as vertical—and, therefore, exempt from per se illegality. While Justices Harlan, Frankfurter and Burton accepted this view in their dissent,⁷⁰ Chief Justice Warren, writing for the majority, stated:

[McKesson] . . . urges that what would be illegal if done between competing independent wholesalers becomes legal if done between an independent wholesaler and a competing wholesaler who is also the manufacturer of the brand product. This is so, appellee [McKesson] maintains, because in contracting with independent wholesalers it acted solely as a manufacturer selling to buyers rather than as a competitor of these buyers. But the statutes provide no basis for sanctioning the fiction of McKesson, the country's largest drug wholesaler, acting only as a manufacturer when it concludes "fair trade" agreements with competing wholesalers. These were agreements "between wholesalers."⁷¹

McKesson's relevance to the law of dual distribution may seem remote since: 1) the matter involved *price* restraints which are treated harshly by the law even in a vertical context;⁷² and 2) the case was an exercise in statutory construction of an exemption repealed twenty years later. Nevertheless, even the cases that characterize *nonprice* restraints

69. *Id.* at 313. As characterized by the Court: "the crucial inquiry is whether the contracting parties compete with each other. If they do, the Miller-Tydings and McGuire Acts do not permit them to fix resale prices." *Id.*

70. See *infra* text accompanying notes 198-204.

71. *Id.* at 312. This cited passage demonstrates formalism at its extreme. In effect, Chief Justice Warren stated that McKesson wore two hats—that of a manufacturer and that of a wholesaler—and behaved in a radically different manner depending on which hat was being worn. But as explained in *supra* text accompanying notes 56-64, this rationale fails for two reasons. First, no matter which hat is being worn, McKesson's interest is the same—to gain maximum interbrand revenues and profits. Second, given the first reason, McKesson has no incentive to impose restrictions on independent wholesalers that will interfere with their mutual interests.

72. Some commentators argue that vertical price restraints should be governed by the rule of reason. See 1983 *Antitrust Developments*, *supra* note 57, at 385 & n.8; Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 8-14 (1981) [hereinafter *Next Step*]. Posner contends that the price/non-price distinction is "indefensible." *Id.* at 9.

by dual distributors as horizontal rely on *McKesson* either directly or indirectly by adopting its analytical framework. Thus, even though *McKesson* was a resale price maintenance case, it remains influential today on the issue of how to characterize restrictions a manufacturer imposes upon independent distributors. By focusing on the "functional level," the Court in *McKesson*, viewed the relationship between a dual distributor and its independent distributors as one between horizontal competitors rather than that of a complex vertical arrangement.

McKesson's formalistic approach to analyzing restrictions placed upon distributors influenced almost all dual distribution cases decided prior to *Sylvania*. For example, *Interphoto Corp. v. Minolta Corp.*⁷³ involved territorial and customer restraints and resale price maintenance imposed by a camera manufacturer (Minolta) on its distributors. Dual distribution issues arose from Minolta's competition with its distributors in the sale of photographic equipment to retail dealers. The district court found each of these distributional restraints to be per se violations of section 1 of the Sherman Act.⁷⁴

The primary issue in *Interphoto* was Minolta's customer allocation system, by which Minolta reserved to itself the right to deal with United States military exchanges. The court rejected Minolta's justification that such accounts required special handling. The court took an especially dim view of any practices emanating from the manufacturer which operated "coercively" on distributors or which interfered with their "unfettered discretion."⁷⁵ In this light, the court's characterization of Minolta's customer and territorial allocation system as horizontal is not surprising.⁷⁶

After *Interphoto*, courts routinely characterized dual distributors' territorial allocation schemes as horizontal. For example, in *Hobart Brothers Co. v. Malcolm T. Gilliland, Inc.*,⁷⁷ a welding manufacturer's

73. 295 F. Supp. 711 (S.D.N.Y.), *aff'd*, 417 F.2d 621 (2d Cir. 1969).

74. *Id.* at 719-20.

75. *Interphoto*, 259 F. Supp. at 719.

76. The Court in *Interphoto* was also heavily influenced by the presence of price-fixing which it regarded as "infecting" the restraints to make them per se unlawful:

The Court, however, restates the established rule that, where vertical territorial restraints are ancillary to price-fixing, or where the price-fixing is an integral part of the distribution system, the price-fixing "infects" the distribution restrictions and renders them *per se* unlawful. . . . Minolta's activities fall within this established rule and are, therefore, *per se* unlawful even if the combination to divide territories is not viewed as being horizontal in nature.

Id. at 720 n.4 (citing *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 375-76 (1967)). In the presence of price-fixing, therefore, it does not matter what form—vertical or horizontal—the territorial restraints take.

77. 471 F.2d 894 (5th Cir.), *cert. denied*, 412 U.S. 923 (1973).

distribution system involving areas of "primary responsibility"—certain areas of which were reserved for itself—was condemned as a "horizontal territorial allocation."⁷⁸ The territorial restriction's elimination of competition "between Hobart and its own distributors" obviously troubled the *Hobart* court.⁷⁹ While the court purported to base its decision upon the economic realities of Hobart's arrangement, in fact, it simply incorrectly labeled Hobart's territorial scheme as horizontal.⁸⁰

The courts' willingness to recognize horizontal problems with territorial restrictions imposed by dual distributors was extended in *American Motor Inns, Inc. v. Holiday Inns, Inc.*⁸¹ In *Holiday Inns*, the Third Circuit confronted a situation involving the denial of a franchisee's request to open a Holiday Inn in Newark, New Jersey. The court ruled that the franchisor's denial violated the Sherman Act because it was made pursuant to a horizontal market allocation system.⁸² The division of territories here had some additional distinguishing characteristics. Holiday Inns was the franchisor for 1380 hotels in the United States, of which 1099

78. *Id.* at 899. The case arose when Gilliland, one of Hobart's distributors, began selling outside his assigned territory. From Hobart's point of view, Gilliland's violations were nothing to trifle with since the exclusive selling area that was invaded was one the manufacturer had reserved for itself. The relationship between Hobart and Gilliland was not the typical dual distribution arrangement, however, because Gilliland was not merely a distributor. Gilliland also manufactured and distributed a product similar to one Hobart produced. Thus, Hobart and Gilliland were dual manufacturer-distributors. Despite this unusual feature, the court did not rely on the fact that the two firms were in competition with each other at the manufacturing level to condemn the territorial restrictions. As the Fifth Circuit observed: "Hobart knew from the beginning that Gilliland was constructing equipment that competed with Hobart's. Hobart . . . was never concerned with this minor competition as long as Gilliland's actions were compatible with the sale of Hobart products." *Id.* at 897.

79. *Id.* at 899.

80. *Id.* The *Hobart* court stated: "It is a per se violation of § 1 for competitors at the same level of the market structure to allocate territories in order to minimize competition." *Id.* (citing *United States v. Topco Assocs. Inc.*, 405 U.S. 596 (1972)). But the *Topco* analogy is not appropriate. *Topco* involved restraints imposed by trademark licensors owned and controlled by their licensees. This horizontal market allocation hardly describes the situation in *Hobart* where the distributors had no control over the allocation of distribution areas. The court in *Hobart* got around the problem by equating the agreement to a horizontal one. "The Hobart distribution agreement, while appearing to allocate territory vertically, in fact, resulted in a horizontal territorial allocation between Hobart and its own distributors. Such an arrangement must be treated as it operated in practice rather than 'as arranged by skillful drafting.'" *Id.* (citing *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964)). Ironically, disagreement exists among scholars as to whether *Topco* was truly a horizontal, interbrand case. Compare Gerhart, *supra* note 57, at 325-27 with *Intrabrand Cartels*, *supra* note 9, at 36-40. Even those who apply economic analysis to these arrangements have a difficult time in cutting through the horizontal/vertical interbrand/intrabrand jungle.

81. 521 F.2d 1230 (3d Cir. 1975).

82. *Id.* at 1253-54.

were owned by independent parties.⁸³ The franchise agreement specified three types of restrictions. First, franchisees were prohibited from owning any hotel other than a Holiday Inn (the "non-Holiday Inn clause").⁸⁴ Second, franchisees could not operate in areas where Holiday Inns-owned hotels were located (the "company-town policy").⁸⁵ Third, even if the first two restrictions were satisfied, existing franchisees could veto the establishment of any new Holiday Inns in their immediate areas.⁸⁶ The court ruled that the company-town policy, standing alone, was reasonable because it was imposed unilaterally by the franchisor.⁸⁷ Also, the non-Holiday Inn clause, standing alone, *might* be valid, but the combination of the company-town policy with the non-Holiday Inn clause was fatal. That combination, according to the court, resulted in a "horizontal conspiracy" to divide territories between Holiday Inns operating on the retail level as a motel-operator and its franchisees.⁸⁸

Two features of the arrangement influenced the court. The first was the veto power that existing franchisees held over a new entry:

By thus permitting its existing franchisees to determine whether a potential competitor would be allowed to enter . . . HI enabled its franchisees already in the . . . area to divide that market between themselves, thus precluding further intrabrand competition. Such conduct constitutes a horizontal market allocation that is a violation of the Sherman Act.

HI's [the franchisor's] action in denying AMI's [the franchisee's] application, according to the trial court, was not taken unilaterally, but rather in concert with one or more of its licensees. If HI had acted independently in refusing AMI's request, such conduct might have been akin to the vertical restraints in *Schwinn*. But where, as here, the action in question is ascertained by the finder of fact to be joint or collaborative, it is sufficient to constitute a "combination or conspiracy" within the meaning of the Sherman Act.⁸⁹

83. *Id.* at 1235.

84. *Id.* at 1238.

85. *Id.* at 1239-40.

86. *Id.* at 1242.

87. *Id.* at 1253.

88. *Id.* at 1253-54.

89. *Id.* at 1242-43 (citation omitted). The distinction the court made between independent and joint action makes little sense from an economic viewpoint. Since both manufacturers' and distributors' interests are advanced by an efficient distribution system, joint behavior to maximize profits should not be presumed to be for anticompetitive purposes. See *Intrabrand Cartels*, *supra* note 9, at 4-6 & n.18.

The second distinguishing feature was that Holiday Inns owned 281 hotels which operated at the same functional level as its franchisees. Citing *Hobart*, *McKesson* and *Interphoto* as authority, the Third Circuit stated:

Acts by a franchisor, such as HI, that create otherwise unreasonable restraints of trade are not insulated from the anti-trust laws by the fact that such company functions as a franchisor as well as a motel operator. . . .

In the present case, since HI, in one of its capacities, was dealing on the same market level as its franchisees, its contracts that, in effect, foreclosed such franchisees from operating either Holiday Inns or non-Holiday Inns in cities where HI operated an inn, except with HI's permission, constitute market allocation agreements among competitors.⁹⁰

If neither the non-Holiday Inn clause nor the company-town policy alone was objectionable, it is difficult to understand why the combination of both policies was harmful. The court, however, was troubled by the de facto veto power of nearby franchisees, which was similar to the "veto of sorts" which nearby grocers exercised over new members in *United States v. Topco Associates*.⁹¹ The court was also troubled because Holiday Inns "was dealing on the same market level as its franchisees."⁹² Finally, the court was concerned by interactions between Holiday Inns and its franchisees that looked like a "combination or conspiracy." Yet, what the court was really attacking was a franchise system in which the franchisor shared operational responsibilities with its franchisees. In effect, the presence of a system similar to that of dual distribution along with joint decision-making powers were factors in transforming otherwise innocent conduct into illegal behavior.⁹³

90. 521 F.2d at 1253-54.

91. *Id.* at 1242-43 (citing *United States v. Topco Assocs. Inc.*, 405 U.S. 596 (1972)). Professor Baker has criticized this aspect of the *Holiday Inns* case. He stated that "[t]he right to veto competing dealers looks suspiciously like an exclusive distributorship" which is treated as *per se* legal by the courts. Baker, *supra* note 9, at 1509 n.159. Ironically, the court in *Holiday Inns* acknowledged this analogy to the exclusive distributorship. See 521 F.2d at 1250.

92. *Id.* at 1254.

93. *Holiday Inns* was followed by and cited in *Pitchford v. Pepi, Inc.*, 531 F.2d 92 (3d Cir.), *cert. denied*, 426 U.S. 935 (1976), which involved territorial restrictions imposed by a manufacturer of scientific instruments who gradually replaced most of its dealers with its own branches. The Third Circuit's analysis did not depart from *Holiday Inns'* formalistic mode:

In the present case, there is evidence that PEI [the manufacturer] responded to branch and dealer complaints about sales made without regard to the territorial allocation and actively sought to prevent entry by one dealer into another dealer's territory. . . . In addition, the record reveals an explicit agreement between PEI and each dealer to divide territories. Thus a horizontal restraint, a *per se* violation of the Sher-

These "horizontal" cases were all decided before *Sylvania* at a time when most vertical restraints were condemned by *Schwinn*. The distinction between vertical and horizontal restraints was for all practical purposes meaningless since the law treated both forms harshly. If a court wrongly classified a vertical restraint as horizontal, no real harm was done besides that inflicted on the state of legal craftsmanship. Perhaps this explains why courts were so sloppy and inaccurate in their characterizations of nonprice restraints in dual distribution cases, even going so far as to characterize obviously vertical restraints as "equivalent" to horizontal ones.⁹⁴

After *Sylvania*, however, the courts generally viewed similar—if not identical—restraints in a more favorable light.⁹⁵ In pre-*Sylvania* cases, it did not matter greatly how restraints imposed by dual distributors were classified. But in cases decided after *Sylvania*, the legality of these restraints turned upon a determination of whether they were "vertical" or "horizontal." Of course, it does not make sense that changes in the legal standard governing nonprice restraints should alter the way courts characterize those restraints. Whether courts were confusing the legal standard with the characterization process or whether changes in the prevailing standard influenced the characterization perception remains a mystery.

The pre-*Sylvania* view of nonprice distribution restraints, however, did not completely vanish after *Sylvania*. Two cases, in particular, decided shortly after *Sylvania*, illustrate how difficult it was for some courts to shift their perception and how assiduously they clung to a mechanical analytical approach. In *Dougherty v. Continental Oil Co.*,⁹⁶ the Fifth Circuit stated that territorial divisions of a dual distributor may still be viewed as horizontal, although it acknowledged that such relationships

man Act, could be found on this record, even if the *Schwinn* prohibition of vertical restraints were not dispositive.

Id. at 104 (citation omitted).

94. See, e.g., *United States v. CIBA GEIGY Corp.*, 508 F. Supp. 1118 (D.N.J. 1976). *CIBA GEIGY* involved a drug manufacturer who sold a drug in bulk to other drug companies, but restricted its resale to specific formulations the manufacturer was not marketing. The court held:

Although these contracts were reached in a vertical, supplier-purchaser, context, they, in fact, were designed to limit horizontal competition between CIBA and its vendees. . . .

Where it is shown, as it is here, that a vertically imposed restraint is intended to suppress horizontal competition, the court will treat the agreement as the equivalent of a horizontal restraint of trade.

Id. at 1146.

95. See *infra* text accompanying notes 107-93.

96. 579 F.2d 954 (5th Cir. 1978).

contained vertical elements. *Dougherty* involved three methods of gasoline distribution by Conoco: sales to independent jobbers, direct sales to consumers and consignments to commission agents. In dictum the Fifth Circuit stated:

The relationship among the defendants has both vertical and horizontal elements. Vertically, Conoco, as a manufacturer and seller of petroleum products, agreed with entities at a lower level of the marketing chain, its jobbers, to sell them assets previously owned by Conoco. Horizontally, Conoco, as an owner and operator of both bulk plants and retail service stations, agreed with entities at the same market level, its jobbers, to sell them assets previously owned by Conoco. Thus, under settled antitrust doctrines, the Conoco-jobber dealings are capable of several characterizations.

....

... Entities in a seemingly vertical relationship may be deemed capable of horizontal restraints if they are actual or potential competitors. . . . Thus since Conoco operated bulk facilities and retail stations at the same marketing level as the jobbers, the arrangement theoretically could be given *per se* treatment as a horizontal market allocation among them.⁹⁷

Despite citing *Sylvania* for authority, a California court adopted a rigid horizontal analysis to a wine producer's territorial division arrangement. In *Guild Wineries & Distilleries v. J. Sosnick & Son*,⁹⁸ the wine producer (Guild) established areas of primary responsibility for its wholesale distributors. When one of the wholesalers began selling in an area where Guild itself was distributing, Guild terminated that wholesaler. The California Court of Appeal ruled that the termination and territorial allocations were illegal.⁹⁹ The court cited *Topco*, *Holiday Inns* and *Hobart* to the effect that such arrangements constituted "horizontal restraints." "It is settled that distributors cannot lawfully agree to divide territories or customers."¹⁰⁰

The court distinguished *Sylvania* because it did not involve dual distribution:

That case held that *vertical*, nonprice restraints by a manufacturer on distributors—e.g., manufacturer allocation of distributor territories—are not automatically unlawful but are to be

97. *Id.* at 958, 959 (citations omitted).

98. 102 Cal. App. 3d 627, 162 Cal. Rptr. 87 (1980).

99. *Id.* at 636-37, 162 Cal. Rptr. at 92-93.

100. *Id.* at 633, 162 Cal. Rptr. at 91.

tested under the rule of reason, i.e., by looking at the economic effects on competition. In that case, . . . [t]he manufacturer did not compete with its distributors. Not only is the case factually inapposite, but the court took pains to note that its decision did not alter the rule as to horizontal restraints: "There may be occasional problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among the retailers. There is no doubt that restrictions in the latter category would be illegal *per se* [.]"¹⁰¹

Guild Wineries, however, does not help us to distinguish horizontal from vertical arrangements. It merely declares that territorial division and customer allocation arrangements imposed by dual distributors are to be treated as horizontal *because* dual distribution is involved. It thus goes farther than any other case in declaring its hostility—when other restraints are involved—to distribution by the manufacturer. Quoting from another case, the *Guild Wineries* court stated:

When a distributor is replaced by another, the public is given a substitute with no diminution in the number of distributors offering services, but when a manufacturer enters the field and then removes a distributor, the public is left with only the manufacturer instead of the manufacturer and the independent distributor.¹⁰²

Commenting on this passage, Professor Tyler Baker observed: "In effect, cases of this kind make the manufacturer's decision to use independent distributors irrevocable."¹⁰³ These cases also reflect an overt hostility towards distribution by manufacturers. In effect, the manufacturer is given only two choices: either to rely on independent firms entirely for distribution or to completely vertically integrate. By discouraging manufacturers from entering the distributional level in competition with their independent distributors, cases such as *Guild*

101. *Id.* at 634-35, 162 Cal. Rptr. at 91-92 (citations omitted) (emphasis in original).

102. *Id.*, 162 Cal. Rptr. at 91 (citing *Industrial Bldg. Materials, Inc. v. Interchemical Corp.*, 437 F.2d 1336, 1342 (9th Cir. 1970)). This passage illustrates legal reasoning at its worst. It ignores, for example, that vertically integrated firms such as Sears Roebuck & Co. do not offer the public the opportunity to deal with an independent distributor for its goods and services. If it is permissible for a firm to initially operate as Sears does, why is it wrong for a non-integrated firm to change its mode of operation to an integrated one? As Professor Baker observes: "There is no antitrust objection to a manufacturer providing its own distribution from the beginning. Therefore, a rule penalizing him for making that decision after starting with independent distributors is hardly likely to favor independent distributors over the long run." Baker, *supra* note 9, at 1512. The court also seems to be confusing intrabrand with interbrand competition.

103. Baker, *supra* note 9, at 1511 n.165.

Wineries ironically discourage the presence of more competition at that level.

The dissent focused on the majority's reasons for imposing distribution restrictions and stated that legality should not turn on how restrictions are labeled—horizontal or vertical—or their source—manufacturer or distributor.¹⁰⁴ Nevertheless, while some recent decisions have adopted the dissent's approach, *Sylvania* has not precluded courts from condemning restrictions imposed by manufacturer-distributors as horizontal restraints which are thus illegal per se.¹⁰⁵ Despite *Sylvania*, one court declared as late as 1979: "Whether a restraint in a dual distribution system is viewed as horizontal or vertical is unsettled" ¹⁰⁶

V. VERTICAL CASES

Altschuler, in his article on dual distribution, observed: "For the most part, decisions supporting the vertical classification of dual distributional restraints share one telling characteristic: almost all of them have appeared in the wake of the Supreme Court's decision in *Sylvania*."¹⁰⁷ This is true even though *Sylvania*¹⁰⁸ did not involve dual distribution. The reason for the change in attitude is due primarily to *Sylvania*'s more favorable treatment of vertical restraints. Although this is irrelevant to the issue of characterization, the change in legal treatment has appar-

104. See *infra* text accompanying notes 205-08. The primary objective of the restrictions was to encourage retailers to engage in promotional presale services to assure the commercial success of Guild's line of wines and to prevent free riding. 102 Cal. App. 3d at 638, 162 Cal. Rptr. at 93-94. These are the same rationales the Supreme Court used in *Sylvania* to justify the imposition of vertical restraints.

105. Lower court decisions have applied a horizontal analysis to restrictions associated with dual distribution. For example, in *Krehl v. Baskin-Robbins Ice Cream Co.*, the district court stated: "An entity occupying . . . a dual role [manufacturing and distribution] is forbidden per se from imposing territorial market restrictions." 78 F.R.D. 108, 123 (C.D. Cal. 1978).

However, this conclusion was later rejected by the Ninth Circuit when it held that "dual distribution systems must be evaluated under the traditional rule of reason standard" absent a showing of "anti-competitive purpose or effect." *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348 (9th Cir. 1982). See *Copy-Data Sys. v. Toshiba Am., Inc.*, 1979-1 Trade Cas. (CCH) ¶ 62,696 (S.D.N.Y. 1979), *rev'd*, 663 F.2d 405 (2d Cir. 1981), *cert. denied*, 474 U.S. 825 (1985) (district court found Toshiba's conduct to be per se violation; Second Circuit declined to apply per se rule recognizing that "territorial or customer restrictions in dual distribution systems affect only intrabrand competition"); see also *Sherman v. British Leyland Motors, Ltd.*, 601 F.2d 429 (9th Cir. 1979) (automobile manufacturer's reorganization of its distribution system—which involved exchanging rights to distribute certain brands and establishment of exclusive territories between manufacturer's subsidiary and an independent distributor—could be deemed a horizontal agreement).

106. *Krehl v. Baskin-Robbins Ice Cream Co.*, 1979-2 Trade Cas. (CCH) ¶ 62,806 at 78,704 (C.D. Cal. 1979), *aff'd*, 664 F.2d 1348 (9th Cir. 1982).

107. Altschuler, *supra* note 9, at 83.

108. See *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

ently altered the courts' perception on other issues. One would have expected that *Sylvania*'s rejection of a formalistic approach in favor of an economic one would have led to a greater tendency to view distributional restraints as benign and even to a tendency to forego the vertical-horizontal test. Although perceptions have changed somewhat, the analysis of distribution issues remains essentially the same as that which prevailed before *Sylvania*. As many of the cases next described illustrate, formalism still thrives post-*Sylvania*. While the legal results have changed, the basis for many of the decisions have not. Indeed, many of the post-*Sylvania* decisions are no less formalistic than their pre-*Sylvania* counterparts. Instead of engaging in an analysis of the likely economic effects, these cases merely redefine the form at issue.

A. Formalistic Cases

One of the first cases decided after *Sylvania* was a Federal Trade Commission (FTC) decision, *In re Coca-Cola Co.*,¹⁰⁹ which challenged territorial restrictions imposed by the famous supplier of syrup. Coca-Cola also became a bottler through the acquisition of some independent bottlers. In the latter capacity, it operated in exclusive territories, along with its independent bottlers. Citing the recently decided *Sylvania* decision, the commission noted that the rule of reason now governed supplier-imposed vertical territorial restrictions.¹¹⁰ The commission then took up the task of classifying Coca-Cola's exclusive territorial distribution system. In doing so, the commission revealed some misgivings with the traditional approach used in classifying restraints:

Admittedly, the line which separates the "vertical" from the "horizontal" forms of a geographic market allocation arrangement is not always as easy to distinguish as the market plane to which they refer might tend to indicate. Both types of restraints at times may, at a given level of production or distribution, exhibit similar competitive characteristics which, on the surface, obscure the firm or firms which are their true source. . . . Consequently, only by ignoring the essential relationships which exist between the respondents and the independent bottlers might it be concluded that the restraints are *Topco*-type "horizontal" market allocations based solely on the fact that respondents operate bottling facilities and are thus potential competitors of the independents, and vice versa.¹¹¹

109. 91 F.T.C. 517 (1978), *rev'd*, 642 F.2d 1387 (D.C. Cir. 1981). See *infra* note 116.

110. 91 F.T.C. at 610.

111. *Id.* at 611 (citation and footnote omitted).

In a footnote, the commission addressed the issues more directly.¹¹² If Coca-Cola took over the bottling operation in a given territory by integrating vertically, the commission stated, "it would, of course, be entering the 'bottling level,' but we do not read *Topco* as condemning this type of dual-distribution program as a horizontal market allocation arrangement."¹¹³ The commission concluded that while Coca-Cola's system had horizontal aspects to it, they were not "predominant."¹¹⁴ Moreover, Coca-Cola's restraints could not be considered horizontal "simply because they now prevent intrabrand competition among independents and Coca-Cola's subsidiaries, whereas previously they functioned as a barrier to intrabrand competition only among independents."¹¹⁵ Despite this apparent appreciation of the nuances in Coca-Cola's distribution system, the analytical framework the commission used was heavily formalistic, employing a rigid horizontal-vertical test rather than focusing on the system's impact on interbrand competition.¹¹⁶

In the shadow of *Sylvania*, the FTC struggled to classify Coca-Cola's system. Other forums, however, had less trouble relying on formalistic shortcuts to come to their conclusions. *H&B Equipment Co. v. International Harvester*¹¹⁷ illustrates such a formalistic shortcut. H&B was a former distributor of Harvester and claimed that Harvester's establishment of a company store in direct competition with H&B, along with distribution restrictions imposed on H&B, created a horizontal conspiracy between Harvester and its other distributors to force H&B out of business. The Fifth Circuit disagreed with H&B, emphasizing the *source*

112. *Id.* at 613 n.14.

113. *Id.*

114. *Id.* at 614.

115. *Id.*

116. Although, the commission declined to apply the *per se* rule to Coca-Cola's territorial restrictions, it nevertheless ruled that they were "unreasonable restraints on trade" when they were analyzed under the rule of reason. *Id.* at 674. Thus, Coca-Cola's victory at the characterization stage was short-lived since the commission condemned its distribution system at the rule of reason analysis stage. For a critique of the commission's handling of that second stage of analysis, see *Rule of Reason*, *supra* note 44, at 6 (arguing that Coca-Cola imposed the system of exclusive territories to encourage franchised bottlers to distribute to high-cost, low-volume outlets in remote areas without losing the more profitable supermarket trade to free-riders). In 1980, Congress responded to the FTC's *Coca-Cola* litigation by passing the Soft Drink Interbrand Competition Act which permits exclusive territories for soft drink distribution. 15 U.S.C. § 3501 (1982). Congress passed the Act to overturn the FTC decision and to protect small independent bottlers. See 126 CONG. REC. 17,713 (daily ed. June 28, 1980). After passage of the Act, upon petition of the soft-drink manufacturers, the court of appeals set aside the commission's order on the ground that the Act was enacted to resolve the litigation. *Coca-Cola*, 642 F.2d at 1390-91. Thus, it took an act of Congress to preserve Coca-Cola's distribution system.

117. 577 F.2d 239 (5th Cir. 1978).

of the dual distribution plan: "Conspiracies between a manufacturer and its distributors are only treated as horizontal, however, when the source of the conspiracy is a combination of the distributors."¹¹⁸

Citing *Sylvania*, the Fifth Circuit continued: "Here the asserted originator of the plan to eliminate H&B was the manufacturer, which allegedly established the company store for that purpose. Consequently, antitrust law treats the conspiracy as a vertical restraint, and those restrictions are now judged under the rule of reason."¹¹⁹

In *Westpoint Pepperell, Inc. v. Rea*,¹²⁰ a dual distributor/manufacturer (Westpoint) transferred part of one distributor's territory to another distributor. Later, the distributor who lost these territorial rights was terminated. The terminated distributor argued that Westpoint's status as a dual distributor transformed its otherwise lawful exclusive distributorship agreement into a horizontal allocation of markets. However, the court in *Westpoint Pepperell* declared that the territorial restraints were vertical because Westpoint was not acting as a competitor of its distributors when it established exclusive territories.¹²¹ It found cases that ruled similar restraints to be horizontal were distinguishable because they involved "territorial restraints which insulated the manufacturer and distributor from competition with one another."¹²²

Although one might agree with the outcome of the latter two cases—that the rule of reason rather than the per se rule should apply to the challenged restrictions—these decisions are unsatisfactory in that they result from application of a formalistic analysis. In *H&B Equipment Co.*, the source of the restrictions was the determining factor; while in *Westpoint Pepperell*, the outcome was still based on a labeling of the restrictions.¹²³ Although such factors are obviously relevant, they do not

118. *Id.* at 245.

119. *Id.* at 245-46. Although the result was different from that of the district court in *H&B*, another district court employed a similar analysis in *Krehl v. Baskin-Robbins Ice Cream Co.*, 1979-2 Trade Cas. (CCH) ¶ 62,806 (C.D. Cal. 1979), *aff'd*, 664 F.2d 1348 (9th Cir. 1982). At issue was the legality of territorial restrictions imposed by an ice cream licensor who competed on the distribution level with its own area franchisors/licensees. *Id.* at 78,702-03. As in *H&B*, the source of the restriction was determinative. Since the restrictions came "from the top," with Baskin-Robbins acting as licensor and not as a competitor with its licensees, they were viewed as vertical. The decision was upheld on slightly different grounds on appeal, *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348. See *infra* text accompanying notes 209-215 for an analysis of the appellate decision.

120. 1980-2 Trade Cas. (CCH) ¶ 63,341 (N.D. Cal. 1980).

121. *Id.* at 75,744.

122. *Id.* at 75,743. This statement makes little sense since exclusive territories alone—which the court found to be legal—insulate exclusive distributors from intrabrand competition of other distributors whether or not those "other" distributors include the manufacturer.

123. The court in *Westpoint Pepperell* also implicitly rejected the notion that a dual distri-

constitute a completely satisfactory economic approach for deciding legality.

B. The Trend Away From Formalism—Cases Incorporating Economic Analysis

Whether a restraint is vertical or horizontal and where a restraint originated are relevant to any economic inquiry into the nature of a distributional restraint. But neither of these factors alone or together is sufficient to constitute an adequate analysis of the economic effects of a challenged restraint as called for in *Sylvania*.¹²⁴ Unfortunately, *Sylvania* did little to assist courts in carrying out such an analysis. At the very least, courts should try to determine the type of competition that is affected by any challenged restraint. Relevant questions include: 1) whether the restraints enable firms to restrict output and raise price; 2) whether they enhance efficiency; and 3) whether they promote or reduce interbrand competition. Since *Sylvania* is concerned only with the impact upon interbrand competition, any restriction which affects only intrabrand competition or which has no adverse impact upon interbrand competition should be governed by the rule of reason. An analysis that merely attempts to assess the form or origin of a restraint does not go far enough because it does not identify the "real" effects of the restraint.¹²⁵

In the relatively brief period since *Sylvania* was decided, some courts have attempted to perform more than the usual simplistic analysis based upon a subjective assessment of form or a search for the origin of a restraint. For example, in *Donald B. Rice Tire Co. v. Michelin Tire Corp.*,¹²⁶ the district court rejected a challenge to a tire manufacturer/distributor's system of restraints on horizontal grounds. Citing *United States v. Arnold, Schwinn & Co.*,¹²⁷ the *Rice* court stated that restraints which dual distributors impose on independent distributors are vertical because their source is the manufacturer.¹²⁸ But the *Rice* court also stated that whether the restraints in question were vertical or horizontal,

bution system somehow transforms otherwise innocent restrictions into per se violations of the Sherman Act. *Id.* at 75,743-44.

124. See *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

125. See generally *Intrabrand Cartels*, *supra* note 9.

126. 483 F. Supp. 750 (D. Md. 1980), *aff'd*, 638 F.2d 15, *cert. denied*, 454 U.S. 864 (1981).

127. 388 U.S. 365 (1967).

128. *Id.* at 754 (citing *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967)). "*Schwinn* . . . suggests that in a dual distribution system where the manufacturer is both supplier and competitor, the restraints imposed are to be evaluated as vertical because '[t]he source of the restrictions is the manufacturer.' " *Id.*

a per se approach was inappropriate.¹²⁹ A rule of reason analysis was mandated, because the manufacturer-imposed restraints were implemented to promote interbrand competition.¹³⁰

On appeal, the result in *Rice* was affirmed, but the Fourth Circuit disassociated itself with much of the lower court's reasoning.¹³¹ Specifically, the Fourth Circuit rejected the lower court's reliance on source as a determining factor: "[w]e must reject, however, any implication . . . that a restraint may always be regarded as vertical if it is imposed by the manufacturer."¹³² Instead of source, the court focused on the purpose of the restraints.¹³³ But in illustrating this point, the Fourth Circuit reverted to formalistic thinking:

Thus we think it is important to distinguish between a conspiracy among dealers and their supplying manufacturer for the purpose of retail price maintenance that would benefit the dealers and one involving the same parties but redounding primarily to the benefit of the manufacturer as a result of increased interbrand competition. A restraint imposed by the former conspiracy would be horizontal in nature and *per se* illegal, while one imposed by the latter would be vertical and analyzed under the rule of reason.¹³⁴

The flaws in the Fourth Circuit's reasoning center on: 1) its assumption that joint distribution agreements can benefit distributors or manufacturers, but not both,¹³⁵ and 2) its acceptance of the formalistic vertical-horizontal framework for characterizing restraints. The Fourth Circuit, however, did redeem itself somewhat when it accepted the lower

129. *Id.*

130. *Id.*

131. Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15, *cert. denied*, 454 U.S. 864 (1981).

132. *Id.* at 16.

133. *Id.* at 16-17.

134. *Id.* Unfortunately, the economic reasoning of the first clause of the first sentence is flawed. Manufacturers usually impose retail price maintenance (RPM) for *their own* benefit or the joint benefit of the manufacturer and its distributors. Moreover, despite its harsh treatment by the law, RPM can be and often is adopted for efficiency reasons. See RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE, FED. TRADE COMM., STAFF REPORT OF THE BUR. OF ECON. (Nov. 1983); *Rule of Reason*, *supra* note 44, at 3-4; Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960).

135. See *supra* text accompanying note 63 for a critique of this assumption. Baker, *supra* note 9, at 1492-93 n.113 also points out that it is wrong to assume that a restriction is either manufacturer or dealer imposed. It may result from some combination of the two. "There is, however, no reason to believe that these polar positions exhaust the range of possibilities." *Id.* Another flaw is the implication that resale price maintenance benefits the dealers, rather than the manufacturer. See *supra* note 134.

court's second rationale for applying a rule of reason standard because "the restraints were for the purpose of promoting interbrand competition."¹³⁶ Thus, this case represents a blend of formalism and economic analysis. On the one hand, it rejected characterizing restraints based solely on source and instead looked to the economic purpose of such restraints. On the other hand, it utilized a vertical-horizontal demarcation and assumed that all joint behavior was collusive in nature.

*Red Diamond Supply, Inc. v. Liquid Carbonic Corp.*¹³⁷ was another case that attempted to incorporate an economic analysis of the effects of dual distribution. In *Red Diamond*, a distributor (Red Diamond) alleged that a conspiracy existed between a manufacturer/distributor (Liquid) and its three distributors to maintain territorial and customer restrictions on sales of Liquid's products. The Fifth Circuit ruled that the restrictions were vertical in nature because their source was the manufacturer.¹³⁸ The Fifth Circuit also explained why the source was determinative:

The reason for focusing on the source of restraints on distributors is economic. Distributors have an incentive to agree among themselves to restrict competition, such as by allocating territories, in order to raise the price they receive for their product because to do so normally increases their profits. Such a horizontal conspiracy, which generates simply an increase in prices, is generally detrimental to consumers and is illegal *per se*.

Not only does a horizontal conspiracy among distributors hurt consumers, however; it injures the manufacturer as well because the higher retail price of the product reduces the quantity sold at retail and hence the quantity demanded from the manufacturer. A manufacturer generally prefers that its distributors sell its product for as low a price as possible, given the price at which it sells the product to them, i.e., for as small a markup as possible over the wholesale price, because its sales of the products are normally greater the lower the retail price. A manufacturer thus will typically encourage intrabrand competition in order to enhance interbrand competition, i.e., the competitiveness of its product with those of other manufacturers.¹³⁹

136. *Rice*, 638 F.2d at 16-17.

137. 637 F.2d 1001 (5th Cir.), cert. denied, 454 U.S. 827 (1981).

138. *Id.* at 1004 & n.4.

139. *Id.* at 1004 n.4 (citation omitted). The court's reasoning regarding dealer-initiated restrictions is generally correct where they are implemented without the involvement of the

The *Red Diamond* court then explained that a manufacturer's imposition of restrictions on its distributors may increase interbrand competition:

Sometimes, however, a manufacturer will find it advantageous to impose restrictions, such as assigned territories, on its distributors in order to induce them to undertake advertising or promotional activities, to render more or better services to customers, or simply to push the product more vigorously. By facilitating such efforts on the part of distributors, the restrictions tend to increase retail sales of the product, and may do so on balance even if they also generate some increase in the price the distributors charge. Thus, restrictions on intrabrand competition are sometimes a means whereby a manufacturer can increase interbrand competition. Because increasing interbrand competition is generally socially desirable and because intrabrand restrictions are generally not socially harmful when there is significant interbrand competition, manufacturer-imposed, i.e., vertical, restraints are governed by the rule of reason.¹⁴⁰

Citing *H&B Equipment Co. and Coca-Cola Co.*, the *Red Diamond* court then rejected the notion that the presence of dual distribution somehow infected these vertical restraints. In addition, the court suggested and offered an economic rationale for the practice:

That Liquid also distributed some of its own goods does not alter the situation. When a producer elects to market its goods through distributors, the latter are not, in an economic sense, competitors of the producer even though the producer also markets some of its goods itself; rather, the distributors are "agents" of the producer, employed because the producer has determined that it can supply its goods to consumers more efficiently by using distributors than it can by marketing them entirely by itself.¹⁴¹

In this important passage, the court rejected the legal community's conventional view that dual distributors compete with their independent dis-

manufacturer or supplier. The reasoning does not apply, however, where the manufacturer is involved for reasons cited in *supra* note 63. Even where the manufacturer is not involved, interbrand competition should constrain a dealer's price raising freedom. See also *supra* note 60.

140. *Id.* The only problem with this passage is the implication that a restriction desired or imposed by dealers could not be adopted to enhance interbrand competition.

141. *Id.* at 1004-05 (citing *H & B Equipment Co. v. International Harvester*, 577 F.2d 239 (5th Cir. 1978) and *In re Coca-Cola Co.*, 91 F.T.C. 517 (1978), *rev'd*, 642 F.2d 1387 (D.C. Cir. 1981)).

tributors. Instead, the court recognized that dual distribution merely represents one way by which a manufacturer markets its goods. Also noteworthy is the decision's implied recognition of the mutuality of interest of the manufacturer and distributors in maximizing profits. The Fifth Circuit ultimately found the restrictions legal under the rule of reason because: 1) they did not harm, but instead improved interbrand competition and 2) to hold otherwise would have created an incentive for vertical integration, thus eliminating independent distributors.¹⁴² Commenting on the second rationale, the Fifth Circuit reasoned:

Liquid most probably could have chosen, consistent with the antitrust laws, to do all of its own distributing . . . either by cancelling its distributors and expanding internally or by simply acquiring the distributors themselves. If Liquid had thus vertically integrated into distributing, it clearly could have instructed its employees to abide by territorial and customer restrictions. And since Liquid could have accomplished these ends by either internal expansion or merger, either of which would have had an even greater impact on intrabrand competition, we fail to see why it would have been unreasonable for Liquid to accomplish the same ends by contract.¹⁴³

Red Diamond is thus distinctive for integrating economic insights into a formalistic framework. While the basic approach depended heavily upon the conventional horizontal-vertical and source analysis, the court attempted to examine the underlying purpose of the challenged restraints. Moreover, it recognized that while such restraints could restrict intrabrand competition, at the same time they could enhance interbrand competition.

Abadir & Co. v. First Mississippi Corp.,¹⁴⁴ another Fifth Circuit case, followed *Red Diamond*'s reasoning. In *Abadir*, an agreement between a fertilizer seller (First Mississippi) and an independent trader was held to be vertical.¹⁴⁵ The agreement limited the geographic area in which the trader could resell urea purchased from First Mississippi. The distributor was permitted to resell only in Asia. First Mississippi was a dual

142. *Id.* at 1005-07.

143. *Id.* at 1006-07 (footnote omitted). This important passage points out a fatal flaw in many distributional restraint decisions—the less favorable treatment accorded to contractual integration as compared to ownership integration. While a vertically integrated firm controls the price of its product, a non-integrated firm is forbidden by contract to have the same control over the resale price. See *Knutson v. Daily Review, Inc.*, 548 F.2d 795, 805 n.10 (9th Cir. 1976), *cert. denied*, 433 U.S. 910 (1979).

144. 651 F.2d 422 (5th Cir. 1981).

145. *Id.* at 425.

distributor because it also sold directly to customers. The Fifth Circuit held that *Red Diamond* controlled the legality issue and reversed the district court's holding that the agreement was horizontal.¹⁴⁶

Abadir is interesting not because of its outcome, but because of the rationale it offers for its outcome. The decision seems to reject a classification based on the source of the restriction:

A particular market-distributing agreement is treated as a vertical agreement if the party imposing the agreement has the potential economic advantages typically available to a supplier in a vertical market-distributing agreement. If these potential economic advantages are absent, then the agreement is horizontal.

Thus, it is not decisive whether the party imposing the restriction is a manufacturer. A market-dividing agreement between manufacturers lacks legitimate potential economic advantages, and would be subject to the *per se* horizontal rule as readily as a horizontal agreement between distributors. But a market-dividing agreement between non-manufacturers is vertical if the party imposing the agreement has the potential economic advantages typical of the supplier in a vertical market-distributing agreement.¹⁴⁷

Despite this language, a footnote suggests that source is still important. "Thus, vertical market-distributing agreements must truly be imposed by a supplier, in fact. Market-distributing agreements which are initiated by distributors are horizontal, even if the supplier is nominally a party to the contract."¹⁴⁸ Moreover, the *Abadir* decision exudes less enthusiasm for vertical restrictions where they are imposed by a dual distributor. "[T]hose normal market factors encouraging a supplier to let its distributors compete are less effective to the extent that First Mississippi also competes as a distributor."¹⁴⁹

Nevertheless, the court refused to apply a *per se* rule to the dual distributorship merely because it contained horizontal elements. Citing the Supreme Court's admonition in *Broadcast Music, Inc. v. Columbia*

146. *Id.* at 424, 429.

147. *Id.* at 427 (emphasis added) (footnote omitted). The potential "economic advantages" associated with vertical restrictions are those mentioned in *Sylvania* and *Red Diamond*—attracting competent and aggressive retailers, inducing retailers to engage in promotional activities, promoting market-distribution efficiency and maintaining control over safety and quality of product. *Id.* See *Sylvania*, 433 U.S. at 54-55; *Red Diamond*, 637 F.2d at 1004 n.4.

148. *Id.* at 427 n.5.

149. *Id.* at 427.

Broadcasting Systems,¹⁵⁰ that when applying per se rules "[l]iteralness is overly simplistic and often overbroad,"¹⁵¹ the Court held that the rule of reason was the proper standard to apply to supplier or manufacturer-imposed market divisions because such arrangements have the potential to benefit interbrand competition.¹⁵² "If economic analysis of this case indicates anything, it indicates that agreements of this type have potential legitimate economic advantages, indicating that the rule of reason should be applicable rather than a per se rule."¹⁵³

*Copy-Data Systems, Inc. v. Toshiba America, Inc.*¹⁵⁴ is a case that represents an even greater break with the traditional formalistic approach. *Copy-Data* involved a manufacturer-distributor of office copying equipment and one of its independent wholesalers, who enjoyed exclusive territorial distribution rights that were gradually taken over by the manufacturer. The district court labeled the territorial restrictions "horizontal"¹⁵⁵ and found them to be illegal per se.¹⁵⁶ Relying heavily on *Abadir*, the Second Circuit reversed.

The district court stated that while *Sylvania* permitted manufacturers to impose territorial restrictions on independent distributors, this latitude did not apply where the manufacturer had its own distribution arm. In the latter situation, the district court reasoned, the manufacturer is not attempting to enhance its competitive position against other manufacturers, but is simply protecting itself from price competition from other distributors.¹⁵⁷ Thus, the district court's analysis differed little from that of decisions decided prior to *Sylvania*.

The Second Circuit rejected the district court's formalistic analysis on economic grounds. The court first noted that dual distributorships contain both vertical and horizontal aspects and that numerous decisions have split on the question of whether restrictions imposed by dual distributors are subject to per se or rule of reason analysis. The court then stated that the per se rule does not apply in such circumstances.¹⁵⁸

The Second Circuit answered the district court's concern about the

150. 441 U.S. 1, 9 (1979). See *infra* text accompanying notes 244-58 for a discussion of this case.

151. *Abadir*, 651 F.2d at 426 (citing *Broadcast Music Inc. v. Columbia Broadcast Sys.*, 441 U.S. 1, 9 (1979)).

152. *Id.* at 428.

153. *Id.*

154. 663 F.2d 405 (2d Cir. 1981), *cert. denied*, 474 U.S. 825 (1985).

155. *Id.* at 408.

156. *Id.*

157. *Id.*

158. *Id.* at 408-11.

manufacturer's capacity to restrict competition at the distributor level by stating that the manufacturer "could gain nothing at the distributor level by restricting competition in the intrabrand market."¹⁵⁹ This is the primary implication of what in economics is known as the theory of successive monopoly. The manufacturer, in other words, cannot expand whatever power it already has to increase prices or restrict output by imposing territorial restrictions on its distributors.¹⁶⁰ The Second Circuit implicitly recognized this theory in *Copy-Data*: "TAI [Toshiba America, Inc.] could not increase the prices of its copiers at the distributor level without destroying whatever ability it had to compete successfully in the interbrand market which was dominated by Xerox and which was being flooded by several new manufacturers"¹⁶¹

Without speculating as to the precise goals of the manufacturer, the court stated that the manufacturer may have had legitimate business reasons for imposing restrictions, such as assuring adequate after-sale service.¹⁶² But the Second Circuit went one step further than any previous case. Citing Professor Liebler, the court declared: "[W]e recognize that territorial or customer restrictions in dual distribution systems affect only intrabrand competition."¹⁶³

159. *Id.* at 410.

160. Only one maximum monopoly profit can be obtained in a vertical chain. A manufacturer acting as a monopolist cannot increase its profits by extending its power to the distribution level. Indeed, if the monopolist is already extracting monopoly profits at the manufacturing level, it will want the distribution level to remain open and vigorously competitive. A second output restriction along the vertical chain would reduce profits for all participants including the monopolist. Thus, assuming a manufacturer wants to obtain maximum profits, it can already do so at the manufacturing level without resorting to squeezing its independent distributors. The manufacturer's activities at the distribution level, therefore, should not normally raise any antitrust concerns. This theory is valid, however, only where the output is produced with fixed proportions of manufactured products and distribution services. See *supra* text accompanying notes 61-63.

161. 663 F.2d at 410.

162. *Id.* The Second Circuit explained how intrabrand distributor restrictions could enhance interbrand competition:

In this case, TAI was an insignificant force in the American market for copiers hoping to increase its market share primarily on the strength of a newly developed plain paper copier. To be successful in this quest, TAI not only had to develop a product the quality of which rivaled the offerings of industry giants Xerox and IBM, but also had to assure the availability of prompt and skillful after-sale service on this technically sophisticated machine. The ability of distributors to handle the difficult servicing and maintenance problems associated with plain paper copiers would be of utmost concern to all competent management personnel in companies in TAI's position. In these circumstances, TAI might well have had legitimate reasons, consistent with antitrust law and policy, to restrict *Copy-Data's* freedom to market Toshiba products.

Id.

163. *Id.* at 411 (citing W. LIEBLER, ANTITRUST ADVISOR § 2.20 (2d ed. Supp. 1980)).

Thus, *Copy-Data's* contribution is two-fold: 1) it correctly distinguished between interbrand and intrabrand competition, noting that the impact of a restriction on the former should be the court's only concern and 2) it applied the theory of successive monopoly to the law of dual distribution.

Copy-Data's recognition of the distinction between intrabrand and interbrand competition was followed in *Davis-Watkins Co. v. Service Merchandise*.¹⁶⁴ *Service Merchandise* involved a conflict between Amana, a manufacturer of microwave ovens, and Service Merchandise, a discount retail catalog chain. Service Merchandise objected to Amana's distribution restrictions, which included the use of geographic, customer and location restrictions that prevented distribution to discount retailers such as itself. The legal dispute, however, involved more than Amana's refusal to supply goods to discount dealers. Because Amana also happened to operate several distributorships, Service Merchandise challenged Amana's distributor restraints as constituting an illegal horizontal market division. Instead of becoming immersed in a classification controversy, the Sixth Circuit simply stated that dual distributor restrictions are analyzed by the rule of reason.¹⁶⁵ In reaching its decision, the Sixth Circuit was influenced by Amana's reasons for imposing these restrictions:

Amana required of its distributors and authorized dealers that they provide an acceptable level of required pre-sale, point-of-sale and post-sale services. Consistent with this marketing strategy was Amana's need to eliminate any free riders from its distribution chain. The restrictions were imposed to increase interbrand competition within the microwave oven industry.¹⁶⁶

These reasons are similar to the potential economic advantages cited in *Abadir*, and are typical of those usually mentioned to justify both price and non-price vertical restraints.¹⁶⁷

Service Merchandise also represented a clash between two different styles of marketing. As described by the Sixth Circuit:

At issue in this case are two divergent marketing strategies. Amana's marketing strategy is aimed at enhancing interbrand competition whereas SMC's marketing strategy is aimed at enhancing intrabrand competition. Amana markets its ovens with a strategy of supplying an oven plus services. SMC, on the

164. 686 F.2d 1190 (6th Cir. 1982), *cert. denied*, 466 U.S. 931 (1984).

165. *Id.* at 1196.

166. *Id.* at 1200 (footnote omitted).

167. See *Sylvania*, 433 U.S. at 54-56.

other hand, attempted to market the ovens without supplying any services.¹⁶⁸

Even though Amana's restrictions reduced intrabrand competition, the court applied the rule of reason because the restrictions "also had the potential to promote interbrand competition via efficiencies in the distribution of the Amana product."¹⁶⁹ The efficiencies that the restrictions encouraged included providing point-of-sale services and promotion, and eliminating free riding by retailers such as Service Merchandise. The court recognized the manufacturer's preference for an arrangement that assured that its product would be distributed only when accompanied by dealer-supplied services which would presumably enhance their value to consumers.¹⁷⁰ Had the court ruled otherwise, it would, for all practical purposes, have condemned Amana's system of marketing as well as its mode of distribution.

C. Recent Cases

Recent cases have reaffirmed this line of post-*Sylvania*, decisions that treat restrictions imposed by dual distributors as vertical and/or subject to the rule of reason. Thus, in *Midwestern Waffles, Inc. v. Waffle House, Inc.*,¹⁷¹ where a franchisee challenged territorial restrictions imposed by a fast food franchisor who also operated company-owned restaurants, the court viewed the restraints as vertical and concluded that the rule of reason should apply. The franchisee relied heavily on the fact that Waffle House, which approved franchise territories, also operated some of its own franchises. The court, however, refused to view the arrangement as a per se illegal horizontal market division. The district court stated: "There is an emerging tendency by the courts to view the primary relationship between a dual distributor and an independent franchisee as vertical where the restrictions do not lessen interbrand competition or decrease the availability of goods or services."¹⁷²

In another antitrust matter, the court dismissed an attempt to characterize territorial restrictions imposed by a dual distributor as horizontal by observing: "The better-reasoned decisions have held that a rule of reason analysis is applicable in dual distribution systems."¹⁷³

168. *Service Merchandise*, 686 F.2d at 1195.

169. *Id.* at 1200.

170. *Id.* at 1199-1200. A similar analysis was recently employed by the Supreme Court. See *Business Electronics v. Sharp Electronics Corp.*, 56 U.S.L.W. 4387 (U.S. May 3, 1988) (No. 85-1910).

171. 1983-2 Trade Cas. (CCH) ¶ 65,567 (N.D. Ga. 1982).

172. *Id.* at 68,821.

173. *Jack Walters & Sons Corp. v. Morton Bldgs., Inc.*, 1983-1 Trade Cas. (CCH) ¶ 65,284,

Another recent case, *Graphic Products Distributors v. Itek Corp.*,¹⁷⁴ reaffirms the view that territorial restraints imposed by a dual distributor are to be treated as vertical.¹⁷⁵ *Itek* is noteworthy because its analysis recognizes that reductions on intrabrand competition can enhance the welfare of consumers. The *Itek* court noted:

[A] vertical restraint on trade, almost by definition, involves some reduction in intrabrand competition. When a manufacturer restricts a dealer to selling only within a certain territory, or only to certain customers, or only from certain locations, it is necessarily restraining intrabrand competition. However, this may or may not have a negative effect on the welfare of the consumer The effects of a restraint of intrabrand competition on consumer welfare cannot be viewed in isolation from the interbrand market structure. A restriction of intrabrand competition may—depending on the interbrand market structure—either enhance or diminish overall competition, and hence consumer welfare.¹⁷⁶

While *Itek* distinguishes itself by focusing on consumer welfare, it does note that restraints imposed by dual distributors present greater competitive concerns than do restraints imposed by manufacturers who do not compete with their distributors. Thus, even recent cases cannot escape the position that dual distribution is to be viewed skeptically.

Two other cases, *L.C. Williams Oil Co. v. Exxon Corp.*¹⁷⁷ and *Dimidowich v. Bell & Howell*,¹⁷⁸ were correctly decided. However, in their analysis, both courts struggled soulfully and seemed reluctant to apply a rule of reason standard. In *Williams*, a gasoline distributor (Williams) sued its petroleum supplier (Exxon) for geographically restricting the distributor's access to supply. Williams alleged that such restrictions constituted a horizontal territorial restraint by a dual distributor since Exxon also distributed directly to some service stations. The court ruled that even if William's lack of access to certain Exxon terminals constituted a "territorial restraint"—which it later ruled it did not—the legal-

at 69,668 (E.D. Wis. 1983), *aff'd*, 737 F.2d 698 (7th Cir.), *cert. denied*, 469 U.S. 1018 (1984). Morton manufactured farm, commercial and industrial buildings. Jack Walters was one of Morton's independent dealers. Over the years Morton terminated each of its dealers and gradually assumed distribution itself. Walters was the sole remaining Morton independent dealer before he was terminated.

174. 717 F.2d 1560 (11th Cir. 1983).

175. *Id.* at 1563-65.

176. *Id.* at 1571 (footnote omitted).

177. 625 F. Supp. 477 (M.D.N.C. 1985).

178. 803 F.2d 1473 (9th Cir. 1986).

ity of such a restraint would be determined under the rule of reason.¹⁷⁹ The court's analysis, nevertheless, was unduly narrow. First, it asserted that a "neat distinction" existed between vertical and horizontal restraints.¹⁸⁰ Second, it blindly followed the *United States v. General Motors*¹⁸¹ rule that a supplier-imposed restraint is governed by the per se rule "if done at the horizontal competitors' [the supplier's dealers or distributors] insistence."¹⁸² Third, the court framed the crucial issue in formalistic terms: "The question thus arises whether Exxon was acting as a supplier (in a vertical capacity) or as a competitor distributor (in a horizontal capacity) when it allegedly limited William's territory."¹⁸³

Rather than focusing on the economic impact of Exxon's distribution arrangements, the court fruitlessly attempted to determine which aspect "predominated"—the vertical or horizontal corporate personality.¹⁸⁴ In the end, the court essentially surrendered and declared that a per se standard was not justified.¹⁸⁵

The Ninth Circuit rendered an economically more sophisticated de-

179. *Id.* at 487.

180. *Id.*

181. *United States v. General Motors Corp.*, 384 U.S. 127 (1966).

182. *Williams*, 625 F. Supp. at 487. See *supra* text accompanying notes 52-64 for a critique of the analysis underlying the distinction in the legal treatment of distributional restraints based upon source.

183. *Williams*, 625 F. Supp. at 487. This language reflects a tenet of formalistic thinking—that dual distributors are "competitors" with independent distributors—a premise that *Red Diamond* rejected. 637 F.2d at 1005.

184. Excerpts from the opinion reflect an ambivalent and essentially incoherent attitude toward supplier-imposed restraints where some of the distributors lobby for their imposition:

territorial restraints, made by suppliers acting at the insistence of competitors of a claimant, are judged as per se illegal horizontal restraints despite the other (including legitimate) goals the supplier may wish to achieve. In the instant case, Exxon also has vertical and horizontal pressures for its territorial restraints—and yet its vertical pressures are considered the predominant ones

. . . While horizontal competitors should be prevented from circumventing anti-trust laws by having their supplier do their restraining, and while plaintiffs would face difficulties attempting to disprove a supplier's contention that it was acting independently despite the horizontal competitors' pressures, a per se violation rule does not seem justified in a situation in which a mixed motive is possible. While the horizontal competitors' influence "taints" the supplier's impartiality in imposing territorial restraints and thus perhaps justifies a presumption of unreasonableness, it does not completely eliminate the supplier's ability to individually evaluate the situation.

Williams, 625 F. Supp. at 488-89.

185. The *Williams* opinion also stated:

It is arguable that plaintiffs in the present case should be given even more of the benefit of the doubt in the current situation, in which both the vertical and horizontal pressures emanate from the same corporate structure, making it more difficult to discover which predominated. Nevertheless, the court is unwilling to find that a per se illegality rule is appropriate here.

Id. at 489.

Professor Liebler offered a possible explanation for such a puzzling outcome—although

cision in *Bell & Howell*.¹⁸⁶ *Bell & Howell* involved a manufacturer of microfilm (Bell & Howell) who maintained its own service organizations nationwide except for the southwestern United States, where it authorized an independent firm to service and distribute replacement parts. The use of an independent distributor for part of the country thus made Bell & Howell a dual distributor. Another independent service firm—which previously was part of the Bell & Howell service organization—seized upon this fact as a basis for attacking the arrangement on antitrust grounds when it could not obtain parts from Bell & Howell.¹⁸⁷ In rebuffing the challenge to Bell & Howell's distribution scheme, the Ninth Circuit blended formalism with economic analysis. While justifying its conclusion that the rule of reason applied on the basis of the traditional vertical/horizontal framework, the court did not simply resort to legal pigeonholing. Instead, it went on to explain:

[O]ne justification for rule of reason analysis of restrictions in the context of a dual distributorship is that they provide corresponding benefits in the interbrand market. Because of the vertical element of the alleged "hybrid" agreement, the restriction in the service market may well result in the same type of significant procompetitive effects in the product market as do restrictions in the context of a dual distributorship.¹⁸⁸

The Ninth Circuit also explicitly rejected *Guild Wineries & Distilleries v. J. Sosnick & Son*,¹⁸⁹ one of the leading horizontal dual distribution cases, as "flawed."¹⁹⁰ The court noted that: "Although a manufacturer's relationship with its distributors has an horizontal aspect when it

he was not referring specifically to this case—in view of the court's finding that horizontal factors were present.

A standard based on form, however, tends to dissolve when the arrangement that it makes illegal *per se* creates significant efficiencies. Many courts are reluctant to strike down transactions that are obviously wealth producing. When confronted with efficiency creating arrangements they will often try to avoid holding them illegal *per se*.

1983 *Antitrust Developments*, *supra* note 57, at 386 (footnotes omitted).

186. 803 F.2d 1473.

187. Bell & Howell's policy was to supply replacement parts only to its own service organization or directly to owner users. With the exception of one authorized independent service firm in the southwestern United States, Bell & Howell refused to supply replacements parts to independent service organizations.

188. *Bell & Howell*, 803 F.2d at 1481 (citation omitted).

189. 102 Cal. App. 3d 627, 162 Cal. Rptr. 87 (1980).

190. *Bell & Howell*, 803 F.2d at 1482. The court's rejection of the *Guild Wineries* analysis was especially strong:

The court in *Guild Wineries* decided that a distributor's termination in the context of a dual distributorship arrangement should be judged by *per se* principles. It concluded that when a manufacturer "became a distributor," its relationship with its

acts as a distributor itself, it remains primarily a vertical relationship. A manufacturer retains some right to place restraints on its distributors to improve its ability to compete in the product market."¹⁹¹

Despite demonstrating some economic sensitivity, the Ninth Circuit's decision in *Bell & Howell* was still based on a horizontal/vertical labeling framework. Moreover, the court's adherence to this framework caused it to incorrectly label Bell & Howell's service relationship with its southwestern distributor-servicer as "horizontal,"¹⁹² making the overall relationship a "hybrid" one "composed of both a dual distributorship and a horizontal relationship."¹⁹³

The vertical cases described above reflect an evolution that, from the perspective of economic analysis, is going in the right direction. But even the best of these decisions still considers dual distribution a suspect practice when it is accompanied by restrictions on the freedom of independent distributors. In the next section of this Article, three decisions are discussed which carry the evolution one step further. Unlike the opinions discussed up to this point, the next three do not allow the presence of dual distribution to color their analysis. Instead, they focus directly on the challenged restraints' competitive impact.

fellow distributors was horizontal, and it lost the right to dictate territorial divisions to a "fellow distributor." We suggest the analysis in *Guild Wineries* is flawed. . . .

The approach of the *Guild Wineries* court appears to mischaracterize the dual distributorship arrangement

Id. (citations omitted).

191. *Id.*

192. *Id.* at 1481-82. This classification labeling is odd. If Bell & Howell's relationship with an independent distributor is "vertical" for the purposes of the product market (replacement parts distribution), it should not be any different for the service market. Perhaps the court was confused by the lack of terminology to describe the service component of the arrangement. I suggest that it be termed a "dual servicer" relationship.

193. *Id.* at 1481. In a footnote the court distinguished between "hybrid" relationships involving the same and different products or service markets. The footnote explained:

We note that a "hybrid" arrangement only justifies the application of the rule of reason where the market in which the conspirators are in a vertical relationship is in some way interdependent with the market in which they have a horizontal relationship. The fact that Conglomerate A supplies Conglomerate B with bread to sell in B's retail stores almost certainly has nothing to do with A and B's ability to agree to sell steel at the same price. The latter is still horizontal price-fixing and illegal per se. Only when there is a possibility that the restraint in the market in which there is a horizontal relationship will have significant procompetitive effects in the other market, as is the case when the markets are for the service and the distribution of the same product, is rule of reason analysis appropriate.

Id. at 1482-83 n.6. See *Hobart Bros. v. Malcolm T. Gilliland, Inc.*, 471 F.2d 894 (5th Cir.), cert. denied, 412 U.S. 923 (1973), for another example of a "hybrid" relationship between a supplier and distributor.

VI. INTEGRATING ECONOMIC ANALYSIS INTO
DUAL DISTRIBUTION LAW

By concentrating on the form of the distribution arrangement involved, most decisions fail to evaluate distribution restraints on the basis of economic effect. *Copy-Data Systems v. Toshiba America, Inc.*¹⁹⁴ and *Red Diamond Supply, Inc. v. Liquid Carbonic Corp.*¹⁹⁵ are cases that succeed in analyzing substance over form, but do so within the traditional vertical-horizontal framework. Thus, even these cases do not completely escape the legacy of *United States v. McKesson & Robbins, Inc.*¹⁹⁶ and the influence of the traditional legal approach. It is difficult for most judges to diverge from the traditional approach, not so much because they find the approach compelling, but because it creates a convenient framework. In law, once a framework is established, precedent makes it nearly impossible to successfully challenge conventional wisdom with a different approach.¹⁹⁷ Little room exists for new insights when the preexisting framework is incompatible. Despite the difficulties in incorporating economic analysis into the law of distributional restraints, the three following opinions in particular go farther than most in applying a rational economically-based analysis. Given the intellectual constraints of legal analysis, it is not surprising to discover that two of the three opinions are dissents.

McKesson, a dual distribution matter which had the added element of resale price fixing under the fair trade laws, is the father of the "hori-

194. 663 F.2d 405 (2d Cir. 1981), *cert. denied*, 474 U.S. 825 (1985).

195. 637 F.2d 1001 (5th Cir.), *cert. denied*, 454 U.S. 827 (1981).

196. 351 U.S. 305 (1956).

197. An example of the difficulty of incorporating new intellectual developments occurs in first amendment law. The first amendment fully protects most "noncommercial" speech, but accords only limited protection to "commercial" speech—speech that is related to commercial advertising. See *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council*, 425 U.S. 748 (1976). As with dual distribution, the relevant distinction is based on form, and as with dual distribution, economists are highly critical. Economists do not believe that the commercial-noncommercial distinction is the proper way to analyze speech. Instead, they urge a uniform approach for both forms of speech based upon whether the speech is susceptible to useful regulation, i.e., permitting regulation only where the truth of the speech can be ascertained by regulators regardless of the type of speech involved. But such an approach is impossible as long as courts cling to the judge-made distinction between commercial and noncommercial speech. See Coase, *The Economics of the First Amendment: The Market for Goods and The Market for Ideas*, 64 AM. ECON. REV. 384 (1974); Coase, *Advertising and Free Speech*, 6 J. LEGAL STUD. 1 (1977). The commercial speech doctrine and the traditional legal approach to first amendment issues have also received scathing criticism from constitutional scholars. See Bork, *Neutral Principles and Some First Amendment Problems*, 47 IND. L. J. 1 (1971); Jackson & Jeffries, *Commercial Speech: Economic Due Process and the First Amendment*, 65 VA. L. REV. 1 (1979).

zontal" cases.¹⁹⁸ At the time of that case, manufacturers were permitted to set their distributors' resale prices so long as they did not compete with their distributors. McKesson, however, was a dual distributor. Therefore, the Court held that McKesson was not permitted to set resale prices with "competing" wholesalers. In a sharp dissent, Justice Harlan criticized the majority for basing its decision on form rather than on economic reality. Justice Harlan then analyzed the economics of McKesson's system. Justice Harlan stated that no real difference existed between manufacturers who act as distributors and those who do not. Using their price setting policies as an illustration, Justice Harlan stated:

[T]here is no meaningful distinction between the fair-trade contracts of integrated and non-integrated manufacturers. . . . In both cases price competition in the resale of the branded product is eliminated, and in neither case does the price fixing extend beyond the manufacturer's own product. While the Government concedes the right of a non-integrated manufacturer to eliminate price competition in his products between wholesalers, it finds a vice not contemplated by the Acts when one of the "wholesalers" is also the manufacturer, for then the contracts eliminate competition between the very parties to the contracts. But, in either case, all price competition is eliminated, and I am unable to see what difference it makes between whom the eliminated competition would have existed had it not been eliminated.¹⁹⁹

Justice Harlan's view that the legality of an arrangement or restriction should not depend on the degree of integration of the supplier was sophisticated for its time. His insight was echoed twenty-five years later in the *Red Diamond* case.²⁰⁰ Unfortunately, most decisions today still do not grasp this basic point. Justice Harlan next responded to the majority's argument that since McKesson was a wholesaler and a manufacturer, it was acting in competition with its independent wholesalers.

This verbalist argument can be answered by the equally verbalist one that the fair-trade contracts, being made in connection with the sale of its own branded products, were made by McKesson in its capacity as a "manufacturer" rather than as a competing "wholesaler." Neither argument being more conclusive than the other, the answer to the problem can be found

198. 351 U.S. 305. See *supra* text accompanying notes 68-72 for a discussion of the majority opinion of this case.

199. *McKesson*, 351 U.S. at 318 (Harlan, J., dissenting).

200. See *supra* text accompanying note 143.

only by looking to the purpose of the provisos [of the Miller-Tydings and McGuire Acts] and its relation to the basic policy of permitting resale price maintenance of branded goods.²⁰¹

While this issue arose from an interpretation of the Miller-Tydings and McGuire Acts, it is similar to an issue often litigated in dual distribution cases—whether the restrictions originate from a manufacturer acting as a manufacturer or as a wholesaler. Justice Harlan's dissent recognizes this legal identity crisis as a false issue. Instead, the courts should focus on the purpose and effect of such restrictions. That is, they should focus on whether the restrictions in question affect interbrand or intrabrand competition.²⁰²

In interpreting the Acts, Justice Harlan stated that their "very purpose . . . is to permit a manufacturer to set the resale price for his own products while preserving competition between brands—that is, between the fair-traded item and similar items produced by other manufacturers."²⁰³ But virtually the same thing can be said about the purpose of the antitrust laws regarding nonprice vertical restraints—to permit a manufacturer discretion in distributing *its* products while preserving competition *between* different brands. Twenty-one years after *McKesson*, the Supreme Court concluded that because restraints imposed by the manufacturer for its own products could enable the manufacturer to compete more effectively against other brands, their imposition was consistent with the primary concern of the antitrust laws—to promote interbrand competition. Perhaps the seeds of the Supreme Court's rationale in *Sylvania* were planted two decades earlier in Justice Harlan's discussion of the purposes behind the Miller-Tydings and McGuire Acts in *McKesson*. Justice Harlan's dissent argued:

The vice of price-fixing agreements between those in competition with each other, whether at the manufacturing, wholesaling, or retailing level, is that they can be utilized to eliminate competition *between brands*. . . . I conclude that an integrated manufacturer selling its products under fair-trade contracts to independent wholesalers should be deemed to be acting as a "manufacturer" rather than as a "wholesaler."²⁰⁴

201. 351 U.S. at 319 (Harlan, J., dissenting).

202. While some dealer cartels may be of antitrust significance because they are organized to restrict output, *see infra* note 208, most of those cartels in practice will present no concern simply because it is improbable that the manufacturer will go along with an arrangement that will either reduce its profits or transfer some of them to the dealers. *See Intrabrand Cartels*, *supra* note 9, at 35-36.

203. 351 U.S. at 317 (Harlan, J., dissenting).

204. 351 U.S. at 319-20 (Harlan, J., dissenting) (emphasis in original). Justice Harlan could

In *Guild Wineries & Distilleries v. J. Sosnick & Son*²⁰⁵ a California Court of Appeal condemned a wine producer's territorial and customer allocation agreements with its distributors as a "horizontal restraint" where the producer also distributed its own product. Associate Justice Christian dissented citing *Sylvania*'s call to "assess the intent, competitive impact, and demonstrable economic effect of a nonprice distribution restriction before declaring the restraint to be prohibited by the antitrust laws."²⁰⁶ Justice Christian's dissent is noteworthy for two reasons. First, his opinion eschews formalism, explicitly rejecting the horizontal-vertical framework most courts had adopted. Justice Christian contended:

In the instant case, Guild was both a producer and a distributor of wine, and also used independent wholesale distributors. Whether nonprice distribution restrictions in such a dual distribution system are to be examined under the rule of reason or under the per se doctrine should not turn on whether the restrictions are pigeonholed as horizontal or vertical. This is the type of "formalistic line drawing" condemned in *Sylvania*.²⁰⁷

Second, having dispensed with the horizontal-vertical distinction, Justice Christian attacked another basis most courts, including *Sylvania*, use to determine the appropriate legal standard of per se versus rule of reason—whether the manufacturer or the retailers initiated the restrictions. To Justice Christian, this distinction was merely another version of the artificial horizontal-vertical distinction. His dissent continued:

Whether distribution restrictions are to be examined under the rule of reason or under the per se doctrine should not turn on whether the restrictions were imposed by the manufacturer or by downstream distributors. . . . As Professor Posner points out: "Dealers as well as the manufacturer are hurt by free-riding; it is a detail whether the initiative in seeking to prevent free-riding was taken by the dealers or the manufacturer."²⁰⁸

still have done a better job by explaining why a manufacturer would want to impose resale price maintenance—e.g., to prevent free-riding at the distribution level—and why such a practice posed no antitrust concern. The reason is that resale price maintenance could not increase the manufacturer's market power beyond that which it already possessed.

205. 102 Cal. App. 3d 627, 162 Cal. Rptr. 87 (1980). See *supra* text accompanying notes 98-103 for a discussion of the majority opinion in this case.

206. 102 Cal. App. 3d at 645, 162 Cal. Rptr. at 98 (Christian, J., dissenting).

207. *Id.* (Christian, J., dissenting).

208. *Id.* at 644, 162 Cal. Rptr. at 97-98 (Christian, J., dissenting). Posner, however, recognizes that the dealers' incentives may, at times, depart from those of the manufacturer. In such circumstances, dealers may seek to restrict intrabrand competition to a greater extent than the level desired by the manufacturer. Leaving aside the fact that the dealers may hurt

Justice Christian's dissent thus analyzes distribution restraints on economic grounds where Justice Harlan's dissent and *Sylvania* left off. It represents perhaps the most far reaching rejection of form in evaluating the legality of vertical restraints.

The third contribution to an economic approach to these problems comes from the Ninth Circuit appellate decision in *Krehl v. Baskin-Robbins Ice Cream Co.*²⁰⁹ The court adjudged Baskin-Robbins' three-tiered marketing system legal.²¹⁰ The Baskin-Robbins marketing system involved licensing other ice cream manufacturers, imposing territorial restrictions and reserving some territories to Baskin-Robbins.²¹¹ The *Krehl* opinion is notable for three reasons. First, it greatly emphasized the "primary concern" of antitrust law—the promotion of interbrand competition—rather than the form of such restraints. In a revolutionary manner, the *Krehl* court rejected the illusory test some other courts had used, stating: "[O]ur inquiry focuses not on whether the vertical or horizontal aspects of the system predominate, but rather, on the actual competitive impact of the dual distribution system employed by Baskin-

themselves if they do this—that is, if they restrict output beyond the level required for joint manufacturer-dealer profit maximizing—if Posner is correct, some dealer cartels may be assembled to achieve anticompetitive objectives.

Even though a dealer cartel is usually no worse than a supplier monopoly, this fact is hardly a count in its favor. Intrabrand dealer cartels, however, do not merit per se treatment because such treatment assumes that all such cartels are bad. In other words, even if we reject the view propounded by some that the source of a restriction does not matter, no case can be made that per se treatment is appropriate. For if some intrabrand dealer cartels are good while others are bad, the rule of reason standard is called for to distinguish between them. A simplistic formalistic analysis, however, glosses over these nuances and simply concludes that all such cartels are bad because they are "horizontal." One commentator, on the other hand, believes that all such cartels *involving the supplier* should be permitted. See *Intrabrand Cartels*, *supra* note 9, at 26. See also *supra* note 63. Liebler also stated:

[A]s a practical matter it is impossible to distinguish these conflicting purposes objectively. The practical alternatives are either to permit all restrictions that are prompted by joint reseller activity, or to proscribe them. Since these restrictions will sometimes increase efficiency and will never (given joint profit maximizing behavior) decrease output, we should permit them in all cases.

Intrabrand Cartels, *supra* note 9, at 26 n.76. Whether or not one agrees with this thesis, given that (1) intrabrand dealer cartels involving the supplier will not decrease output, and (2) such cartels *can* increase efficiency, a per se or "horizontal" standard is inappropriate.

209. See *supra* note 22 and *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348 (9th Cir. 1982). The lower court decisions in this matter are discussed at *supra* notes 105 and 119.

210. *Krehl*, 664 F.2d at 1358.

211. The Baskin-Robbins marketing system was comprised of three tiers. At the top, it managed the franchise and selected "area franchisors" who operated at the second level. The area franchisors were independent manufacturers licensed by Baskin-Robbins to manufacture ice cream and to establish and service franchised stores within exclusive territories. Baskin-Robbins also operated at this level as an area franchisor in six exclusive territories. At the third level were the retail franchised stores that sold Baskin-Robbins ice cream products to the public. *Id.* at 1350-51.

Robbins.”²¹² *Krehl* also explained how restrictions on distributors could actually enhance interbrand competition—a view not widely shared in dual distribution cases.²¹³

Second, *Krehl* endorsed the idea that courts should not interfere with a manufacturer’s distribution system absent evidence of harm to interbrand competition.

[M]odern economic thought indicates that the invalidation of a distribution system, absent a showing of anti-competitive effect, may actually retard competition. “Competition is promoted when manufacturers are given wide latitude in establishing their method of distribution and in choosing particular distributors. Judicial deference to the manufacturer’s business judgment is grounded in large part on the assumption that the manufacturer’s interest in minimum distribution costs will benefit the consumer.”²¹⁴

Finally, and perhaps most importantly, *Krehl* attached no stigma to the presence of dual distribution. This third contribution is really a logical extension of the first two. *Krehl* concluded:

It is evident that were BRICO to abandon its area franchisor responsibilities, the system here would be identical to that involved in *GTE Sylvania*. We do not believe that BRICO’s decision to retain these responsibilities in certain areas has any significant effect on competition. Regardless of BRICO’s decision, there would still be fourteen areas, each exclusively served by a single manufacturer-franchisor. Only the identity of the franchisor in a given area is affected by BRICO’s decision to

212. 664 F.2d at 1356. The lower court laid the groundwork for this approach by stating that the legality of a restraint in a dual distribution system may be determined by either of two approaches: (1) by resolving the factual question of whether an arrangement is vertical or horizontal as the FTC did in *Coca Cola*; or (2) by viewing a dual distribution system as a separate business pattern and determining whether it should be subject to the per se rule because it results in anticompetitive interbrand effects. *Krehl v. Baskin-Robbins Ice Cream Co.*, 1979-2 Trade Cas. (CCH) ¶ 62,806 at 78,704 (C.D. Cal. 1979), *aff’d*, 664 F.2d 1348 (9th Cir. 1982).

213. The Ninth Circuit stated:

Indeed, it appears that the distribution system at issue here may have actually fostered interbrand competition. Through the exclusive licensing of independent manufacturers, BRICO was able to expand into new geographic markets and promote the wider availability of its products. This expansion allowed BRICO to grow from a small manufacturer serving only local markets into a vigorous competitor with outlets throughout the world.

Krehl, 664 F.2d at 1356 (footnotes omitted).

214. *Id.* at 1356-57 (quoting *A.H. Cox & Co. v. Star Mach. Co.*, 653 F.2d 1302, 1306 (9th Cir. 1981)).

retain area franchisor responsibilities in certain territories. To invalidate a distribution system on such basis is to revert to the kind of "formalistic line drawing" eschewed by the Court in *GTE Sylvania*.²¹⁵

VII. A SUGGESTED APPROACH TO THE CHARACTERIZATION PROCESS BASED ON ECONOMIC EFFECTS

The previous sections have described the evolution of the law of dual distribution and associated nonprice restraints. The courts have proceeded gradually, perhaps even glacially, in the direction of applying economic factors in their decisions. But, as the cases analyzed previously reveal, even the most enlightened opinions fall short of what an adequate economic analysis requires. In this section, I attempt to provide some guidance on how courts should approach this area of antitrust law. First, I will summarize the major problems plaguing judicial and scholarly analysis in this area. Then, I will describe the specific role that courts play in dual distribution cases. Next, I will highlight the economic policy considerations that courts should consider in dual distribution cases. This will be followed by a description of the analytical framework that courts should apply in these cases. Finally, I will apply this framework to a factual situation derived from a case that was wrongly decided.

A. Major Analytical Problems in Dual Distribution Cases

As previous sections of this Article have revealed, a long history exists of judicial mishandling of the characterization analysis in dual distribution cases. This rudimentary, but crucial, analysis has been plagued by confusion and a lack of coherent thinking. As Professor Gerhart gloomily observed: "In all but the easiest cases, the determination whether to apply the [per se] rule has been troublesome, largely because few coherent, consistent standards have existed for making that determination."²¹⁶

This confusion springs primarily from two sources: 1) the failure of courts to properly distinguish between the two forms of competition at issue—intrabrand and interbrand; and 2) the inability of courts and scholars to recognize the *potential* efficiency enhancing aspects of the

215. *Id.* at 1356.

216. Gerhart, *supra* note 57, at 323. Professor Gerhart's observation pertained to antitrust analysis generally, but is particularly appropriate for describing the state of analysis in dual distribution cases.

challenged arrangements. Courts, especially in dual distribution cases, place undue emphasis on intrabrand competition, even though *Sylvania* declared that interbrand competition is the "primary concern of antitrust law."²¹⁷ This improper focus is exacerbated by the lack of recognition given to potential beneficial effects of various distributional arrangements and practices. The latter failure is due in part to a lack of understanding of the purpose and function of various business arrangements. When courts or scholars do not understand how or why a certain practice works, they usually judge it on the basis of some type of formalistic analysis.

The consequences of such confusion are serious. When courts fail to correctly characterize distributional arrangements, some harmless arrangements—including some beneficial ones—may be improperly condemned.²¹⁸

B. *The Court's Role in Dual Distribution Cases*

The task in most dual distribution cases is two-fold. First, courts must decide whether to apply the per se rule or the rule of reason to the challenged practice. Second, if the challenged practice is *not per se illegal*, then courts must engage in a full-scale analysis of the competitive effects of the practice.²¹⁹ The first step, the characterization process, is

217. *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 52 n.19 (1977).

218. Judicial errors in characterizing distributional arrangements are biased against harmless arrangements. If a court incorrectly decides an arrangement is per se unlawful, there is no opportunity, at the trial level, to correct the error. Erroneous decisions in the other direction—where the court states that the rule of reason standard applies when it should have found that a per se standard applied—can be corrected when the rule of reason inquiry is actually undertaken.

219. This Article is only concerned with the first step—the characterization analysis—since that is the primary issue that is faced in dual distribution cases. The elements of a full fledged rule of reason analysis are discussed in literature pertaining to all nonprice distributional restraints. See generally, *Vertical Restrictions Limiting Intrabrand Competition*, 1977 A.B.A. SEC. ANTITRUST L., MONOGRAPH 2, 53-71, [hereinafter ABA MONOGRAPH]; *Rule of Reason*, *supra* note 44, at 14-20.

The first step is concerned mainly with an arrangement's "potential," while the second step (the rule of reason balancing inquiry) is concerned with resolving whether the potential is "actual." The analysis in the first step, therefore, is not and need not be as comprehensive as that required in the second step of the rule of reason inquiry. Of primary concern is that the court in a dual distribution case initially choose the appropriate legal standard to apply to the arrangement. At this stage, we are not trying to determine the actual market effect of a distributional arrangement or nonprice restriction, although an agreement that is per se illegal is one where *actual* market effect is conclusively presumed to be harmful. Nor are we conducting a full blown economic analysis as would be the case if we were at the second stage rule of reason inquiry. Instead, we are concerned with whether a practice or arrangement is capable of enhancing efficiency and, therefore, promoting consumer welfare, or whether it is capable only of reducing interbrand competition and, therefore, harming consumer welfare.

concerned with whether the challenged arrangement or restriction is *per se* illegal. If it is, then no need exists to go to the second step; the second step is required only if the rule of reason standard applies. Arrangements that always—or almost always—tend to restrict competition are governed by the *per se* rule. Arrangements that *sometimes* restrict competition are governed by the rule of reason and their legality can only be decided after a second stage balancing inquiry is completed.²²⁰

No matter which standard is eventually applied—the *per se* rule or the rule of reason—an analysis of the challenged practice's potential competitive and efficiency impact must first be made.²²¹ The decision to apply the *per se* rule to an anticompetitive arrangement only signifies that a second, more comprehensive analysis—a rule of reason balancing inquiry—is avoided.²²² But application of the *per se* rule does not avoid the necessity of first determining whether it should be applied.²²³

The objective at the characterization stage is to distinguish between those restrictions which are “automatically (*per se*) illegal” and “those whose legality turn[s] on their market effects”²²⁴ To achieve this objective, the court must assess the *likely* effect of a challenged practice or arrangement on interbrand competition and, therefore, on consumer welfare. If done correctly, this inquiry will distinguish between those arrangements which have no efficiency enhancing effects and those that do.

220. Arrangements that *never*, or almost never, are anticompetitive are also governed by the rule of reason, although a rule of reason balancing inquiry is unnecessary. These arrangements, really should be considered *per se* legal. See generally *Next Step*, *supra* note 72.

221. A comprehensive economic analysis at this stage is premature. All that is required is a determination of whether a more complete economic analysis is needed. If one is needed, then the rule of reason standard should govern the legality of the challenged arrangement or restriction.

222. The recent literature on the rule of reason balancing test, however, takes a deeply cynical view of the utility of the standard. For example, the American Bar Association complained of “[t]he lack of an accepted analytic structure.” ABA MONOGRAPH, *supra* note 219, at 54. Further, Posner described the standard as one that “lacks content and so does not provide guidance to judges, juries, or the Federal Trade Commission.” *Next Step*, *supra* note 72, at 8. The literature also dismisses Justice Brandeis’ classic formulation of the standard in *Chicago Bd. of Trade v. United States*, 246 U.S. 231 (1918), as being “exceedingly general,” ABA MONOGRAPH, *supra* note 219, at 53, and “not . . . helpful” for guiding courts. *Rule of Reason*, *supra* note 44, at 15.

223. Professor Gerhart describes the task that courts must first undertake as follows: “no decision to apply a *per se* rule can be made until after analysis, however rudimentary, of whether the rule should be applied.” Gerhart, *supra* note 57, at 323.

224. Liebler, *1984 Economic Review of Antitrust Developments: Horizontal Restrictions, Efficiency, and the Per Se Rule*, 33 UCLA L. REV. 1019, 1026 (1986) [hereinafter *1984 Antitrust Developments*]. Arrangements that are *per se* illegal are also technically ones in which the arrangements’ illegality turns on their market effects. However, those effects are already known by experience to be harmful.

C. General Economic Considerations at the Characterization Stage

1. Consumer welfare model

From an economic perspective, the overriding goal of antitrust is to maximize consumer welfare.²²⁵ The mistake, however, of associating consumer welfare exclusively with price competition must be avoided. Under this naive view, consumer welfare is maximized by arrangements that minimize the price consumers pay for a product. This view of consumer welfare is too narrow because consumers also benefit from *non-price* or service competition. Indeed, firms often use vertical restraints to achieve *nonprice* objectives—i.e., to assure that retailers provide adequate services and promotion, to prevent other retailers from “free riding,”²²⁶ or to overcome supplier/distributor conflicts. Vertical restrictions on intrabrand competition that are necessary to provide additional services may lead to higher prices for consumers, but can, nevertheless, enhance consumer welfare when the value of these services is taken into account.²²⁷

A more sophisticated economic model of consumer welfare recognizes that consumers are interested not only in low prices, but in a mix of

225. See Baker, *supra* note 9, at 1458. Baker states: “The organizing principle . . . is the assumption that the proper function of the antitrust laws is to maximize consumer welfare by enhancing and protecting competition. This is a powerful idea, capable of illuminating many problems of antitrust analysis that have been perceived only dimly.” *Id.* See also Gerhart, *supra* note 57, at 321 (“a reorientation of substantive antitrust policy around the consumer welfare model—was also endorsed by the . . . Supreme Court”).

226. The free rider problem occurs when a full-service dealer loses sales to a nearby discounter who provides no services. Typically in these circumstances, consumers will go to the full-service dealer for pre-purchase information and post-service warranty service, but make their actual purchase from a discounter. The discounters, as well as the consumers, are taking advantage of the full-service dealer. If such opportunistic behavior becomes widespread, eventually no distributors will provide consumers with information or service, and thus consumer welfare will be diminished. The supplier who wants to assure that such information or services are provided will impose restrictions on all dealers to eliminate free riding by the discounting dealers. See also *supra* note 57 and *infra* notes 227 & 252.

227. One commentator explained this point as follows:

Virtually all of the justifications for vertical nonprice restrictions endorsed in *Sylvania* assume an indirect effect on price. For example, the Court referred to “market imperfections such as the so-called ‘free rider’ effect” that might discourage retailers from providing the appropriate level of services. The same discounters that provide the price competition favored by the enforcement agencies may also “free ride” on the efforts of authorized dealers. A “free rider” takes advantage of a competitor’s investment and charges a price lower than the competitor’s, thereby preventing the competitor from recouping its investment. The elimination of free riders may encourage investment, but it also may increase prices. For this reason, a rule condemning all vertical restrictions having an indirect effect on price is flatly inconsistent with *Sylvania*.

Baker, *supra* note 9, at 1467 (citing *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977) (footnote omitted)).

price, quality, information and service. A restriction on distribution that promotes consumer welfare, according to Posner, is one that gives consumers "their preferred mix of price and service."²²⁸ The characterization analysis, therefore, should recognize that trade-offs between price and services are normal and do not necessarily adversely affect consumer welfare.

2. The "Primary Concern"—interbrand competition

In *Sylvania*, the Supreme Court made clear that consumer welfare is correlated with the level and vitality of *interbrand* competition. Moreover, the *Broadcast Music* Court explicitly recognized the important role that efficiency plays in promoting interbrand competition.²²⁹ Thus, when we refer to arrangements that promote consumer welfare, we are talking about those arrangements that increase efficiency and, therefore, enhance interbrand competition.

In *Sylvania*, the Supreme Court made two important observations that are consistent with this consumer welfare model. First, the Court declared that antitrust law's "primary concern" is with interbrand competition, not intrabrand competition.²³⁰ Second, the Court stated that "[t]he degree of intrabrand competition is wholly independent of the level of interbrand competition confronting the manufacturer."²³¹ Taken

228. *Next Step*, *supra* note 72, at 20. Earlier in his article, Posner explained why the courts should not prefer one form of competition (price) to that of another (nonprice):

[C]ompare two distribution systems, of manufacturers *A* and *B* respectively. *A* does not impose any restrictions on the distribution of its product. As a result, its dealers and distributors provide little or no information or other services with the product, and its retail price is therefore low. *B* does impose restrictions; its dealers, therefore, do provide extensive services, and the retail price of its product is higher. In which distribution system is there more competition? In *A*'s, because prices are lower, or in *B*'s, because services are greater? If competition is defined simply as rivalry, rather than as a device for maximizing consumer welfare or economic efficiency, there is no way to answer such questions, save by an arbitrary preference for price over service competition, or for the reverse. . . . [A preference towards price competition] would amount to saying, without any basis in fact or theory, that the services that restricted distribution encourages are inherently less important—to the consumer, the courts, or the framers of the Sherman Act—than the physical product with which the services are sold, even though the product may be worth much less to the customer without the services than with them.

Id. at 19 (footnotes omitted).

229. In formulating a standard to characterize a distribution arrangement, the court looks to see whether the arrangement was designed to "increase economic efficiency and [thus] render markets more, rather than less, competitive." *Broadcast Music, Inc. v. Columbia Broadcast Sys.*, 441 U.S. 1, 20 (quoting *United States v. United States Gypsum Co.*, 438 U.S. 422, 441 n.16 (1978)). In economic language, consumer welfare is enhanced "by increasing productive and allocative efficiency . . ." Gerhart, *supra* note 57, at 321.

230. *Continental T.V. Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 52 n.19 (1977).

231. *Id.* This part of footnote 19 receives much less attention than the oft-cited "primary

together, these two ideas imply that so long as interbrand competition is not adversely affected, a manufacturer should have substantial discretion to impose restrictions on intrabrand competition.²³² A manufacturer may restrict distribution to be more competitive with other manufacturers—i.e., to promote interbrand competition.²³³ A manufacturer may also impose restrictions to provide consumers with a better mix of price and service. A substantial reduction in intrabrand competition, therefore, is not inconsistent with the promotion of interbrand competition and consumer welfare.²³⁴

Since the “primary concern” of antitrust law centers on interbrand competition, considerations which do not focus on this particular form of competition arguably are largely irrelevant. Thus, concerns about where

concern” language appearing earlier in the footnote. The Court goes on to explain why interbrand competition is the focus of its attention.

[T]here may be fierce intrabrand competition among the distributors of a product produced by a monopolist and no intrabrand competition among the distributors of a product produced by a firm in a highly competitive industry. But when interbrand competition exists . . . it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product.

Id.

232. This is also implied by the Court’s language in another footnote implicitly rejecting the “least restrictive alternative.” “The location restriction used by *Sylvania* was neither the least nor the most restrictive provision that it could have used. But . . . a *per se* rule based on the nature of the restriction is, in general, undesirable.” *Id.* at 58 n.29 (citation omitted). While some commentators argue that a failure to use a lesser form of restriction should be *per se* illegal, see, e.g., Pitofsky, *supra* note 15, at 14, the ABA notes that “no court in a vertical distribution case has ever held that the existence of less restrictive alternatives constitutes proof of unreasonableness as a matter of fact and no court in a non-*per se* case has determined the legitimacy of a restraint by examining the feasibility of alternatives.” ABA MONOGRAPH, *supra* note 219, at 59.

233. Posner put it more concisely: “economic theory . . . teaches that a manufacturer will (unilaterally) restrict distribution only in order to be more competitive.” *Next Step*, *supra* note 72, at 23. See also Baker, *supra* note 9, at 1511. Others argue that Posner’s statement is valid whether or not the restrictions are imposed “unilaterally.” See *Intrabrand Cartels*, *supra* note 9, at 5, 9.

234. *Sylvania*, 433 U.S. at 54-55. Those who are troubled by reductions in intrabrand competition who, nevertheless, recognize that such reductions may be a necessary or lesser evil to promote interbrand competitiveness, sometimes propose balancing the two forms of competition to resolve a restriction’s legality at the rule of reason stage. In other words, they propose weighing the loss in intrabrand competition with the gain in interbrand competition and basing the legal outcome on which effect preponderates. Most scholars who have considered this test have rejected it. See, e.g., *Next Step*, *supra* note 72, at 8 (concluding that such a balancing is “infeasible and unsound.”). See also *Intrabrand Cartels*, *supra* note 9, at 3 n.11; Pitofsky, *supra* note 15 at 36; and *Rule of Reason*, *supra* note 44, at 16-17. However, a fair implication of *Sylvania* is that measurement of such a tradeoff is proper. This implication represents dubious policy not so much because measuring such a tradeoff is infeasible, but because it is unsound. The proper tradeoff is not between intra and interbrand competition, but between efficiency enhancing and output restricting effects on interbrand competition.

a restriction originated,²³⁵ whether a supplier reserves certain territories or customers for itself,²³⁶ whether restrictions merely "reduce" intrabrand competition or are "airtight" and thus eliminate it,²³⁷ or even whether a restriction or arrangement is horizontal or vertical²³⁸ are misplaced. Such concerns only address the state of intrabrand competition, without explaining how such intrabrand restrictions affect output, interbrand competition and consumer welfare.

That is not to suggest that these arrangements will never adversely affect consumer welfare. But the law should not be quick to condemn arrangements because at first blush they resemble a horizontal conspiracy. It is too easy to fall for such superficial appearances and to incorrectly apply a monopoly or anticompetitive explanation. The failure to examine the likely effects of such arrangements may unnecessarily condemn arrangements that not only are not harmful, but are beneficial to consumers.

Thus, under the consumer welfare standard, as well as the legal standard articulated by the Court in *Sylvania*, a court's initial inquiry should focus on how a practice or arrangement affects interbrand competition.²³⁹ The inquiry should be directed at assessing the potential of the challenged practice or arrangement to either enhance or harm this form of competition. Furthermore, the antitrust laws should never automatically penalize nor generally stand in the way of efficient arrangements or restrictions that enhance efficiency.²⁴⁰ The per se rule in particular should be applied "only to arrangements that have a capacity to restrict

235. See, e.g., *Sylvania*, 433 U.S. at 58 n.28; *United States v. General Motors Corp.*, 384 U.S. 127 (1966); *Baker*, *supra* note 9, at 1519. But see *supra* text accompanying notes 52-64.

236. Compare *Pitofsky*, *supra* note 15, at 28 and ABA MONOGRAPH, *supra* note 219, at 42 n.161 with *Schwartz and Eisenstadt*, *supra* note 2, at 71-73.

237. Compare *Pitofsky*, *supra* note 15, at 8-9, 27-29, 34, with *Baker*, *supra* note 9, at 1513-14. For three reasons, even complete elimination of intrabrand competition arguably should not cause concern. First, the Court in *Sylvania* repeatedly intimated that interbrand competition is more important than intrabrand competition. *Rule of Reason*, *supra* note 44, at 10-11. Second, as *Liebler* stated, "[i]ntrabrand arrangements do not increase market share in and of themselves." *Intrabrand Cartels*, *supra* note 9, at 19 n.61. Third, complete elimination of intrabrand competition also occurs as a result of vertical integration, which is considered legal. Yet vertical restrictions are simply contractual substitutes for "what a vertically integrated firm would achieve through internal command." *Baker*, *supra* note 9, at 1490. It does not make sense to outlaw a restriction required by contract while tolerating the same restriction which results from an ownership arrangement.

238. See *Intrabrand Cartels*, *supra* note 9, at 8 & n.24.

239. 433 U.S. at 52 n.19 (this follows from the court's statement that such competition "is the primary concern of antitrust law").

240. As Professor *Hovenkamp* eloquently stated: "[C]ondemnation of a vertical restraint capable of substantial efficiencies is manifestly contrary to the consumer welfare principle." *Hovenkamp*, *supra* note 3, at 1315.

output without creating efficiency."²⁴¹

D. An Analytical Framework Based on Economic Effects

The typical dual distribution case involves a supplier who distributes through wholly owned distributors, as well as through independent distributors, and imposes a number of territorial and customer restrictions on both types of distributors. At the characterization stage, a court must evaluate both the dual distribution arrangement itself and the restrictions that are being challenged. Most of the time, the supplier imposes restrictions on the distributors—both independent and company-owned. However, since the restrictions are usually subject to negotiation by contract, it can hardly be said that they are imposed "unilaterally." Nevertheless, the restrictions sometimes are imposed or enforced at the request of one or more of the distributors. The source of a restriction, as we have seen, should not be determinative.²⁴²

The legality of a dual distribution arrangement *by itself*—independent of any accompanying restraints on distribution—should almost never be questioned.²⁴³ The manner in which a supplier distributes its product should not raise any interbrand competitive concerns. In other words, how a supplier distributes is a matter that should be left to the supplier's discretion.

The restrictions that accompany a dual distribution arrangement may raise independent concerns. How to characterize these restrictions is something that has troubled courts and scholars for many years. In a case decided two years after *Sylvania*, the Supreme Court formulated a standard which is soundly based on consumer welfare principles. In *Broadcast Music, Inc. v. Columbia Broadcasting System*,²⁴⁴ a case involving the legality of blanket licenses to copyright musical compositions, the Court laid out a simple two-step test for characterizing conduct: 1) whether a challenged restriction has the potential to increase efficiency;

241. 1984 *Antitrust Developments*, *supra* note 224, at 1019-20 (footnote omitted).

242. See *supra* text accompanying notes 52-64.

243. The following passage summarizes why dual distribution is regarded in a benign manner:

The point is that dual distribution restrictions are pure intrabrand restrictions. They can never involve a market share larger than that enjoyed by the manufacturer itself. The fact that a manufacturer also operates some dealerships has no more effect on generic market share than would be the case if the manufacturer operated none or all of the reselling establishments.

Intrabrand Cartels, *supra* note 9, at 50 (footnote omitted).

244. 441 U.S. 1 (1979). The analytical framework described here based on the *Broadcast Music* standard was formulated by Professor Liebler. It is exhaustively treated in 1983 *Antitrust Developments*, *supra* note 57.

and 2) whether the challenged restriction increases the ability to restrict output. Both inquiries are economic ones that force the court to determine the likely impact of an arrangement.²⁴⁵

Therefore, under the *Broadcast Music* standard, the appropriate inquiry is whether the arrangement or restriction has an efficiency creating potential. In other words, is an arrangement's possible or likely effect to be efficiency enhancing, and thus procompetitive? If so, the per se rule is inappropriate. In the other extreme, if the *only* likely impact of an arrangement is to restrict output—and thus increase market power by itself—then the per se rule is appropriate.²⁴⁶ The *Broadcast Music* test only addresses these two extreme situations. However, for those situations where an arrangement involves a hybrid of the two extremes, or involves neither, Professor Liebler has argued that a proper characterization analysis must reject application of the per se rule since that rule applies only when the restraint is *certain* to adversely affect competition.²⁴⁷ Thus, where an arrangement has both output restricting and efficiency creating effects, a rule of reason inquiry is necessary to determine which effect is preponderant.²⁴⁸ If an arrangement has neither an efficiency creating potential nor an output restricting capacity, the arrangement is neutral as far as consumer welfare is concerned and probably should raise no antitrust concern.

To summarize, the concern of antitrust law at the characterization stage under this standard is with those arrangements which will restrict output *and* which have no efficiency creating potential. In these circumstances, a per se rule is appropriate. But where the arrangements have a legitimate efficiency enhancing potential, the per se rule is inappropriate. Similarly, where the potential effect is neutral—neither output restricting nor efficiency enhancing—the per se rule should not apply. Thus, at the

245. In outlining its standard for choosing the appropriate legal standard, the Court makes clear that the inquiry is aimed at discovering the purpose as well as the likely effect of an arrangement:

[I]n characterizing this conduct . . . our inquiry must focus on whether the effect and, here because it tends to show effect . . . the purpose of the practice are to threaten the proper operation of our predominantly free-market economy—that is, whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output . . . or instead one designed to “increase economic efficiency and render markets more, rather than less, competitive.”

441 U.S. at 19-20 (citations omitted).

246. More precisely, the per se rule applies only when the likely impact of an arrangement or practice is to restrict output *without* creating any efficiencies.

247. *1983 Antitrust Developments*, *supra* note 57, at 394-95.

248. If an arrangement has anticompetitive as well as efficiency enhancing aspects, the per se rule should not apply. However, if the anticompetitive aspect overwhelms the efficiency effect, then the arrangement should be condemned under the rule of reason.

characterization stage, courts should first determine in which pigeonhole an arrangement fits.

- | | |
|--|---|
| <p>A. Output Restricting Capacity
No Efficiency Creation Potential</p> | <p>C. No Output Restricting Capacity
No Efficiency Creation Potential</p> |
| <p>B. Output Restricting Capacity
Efficiency Creation Potential</p> | <p>D. No Output Restricting Capacity
Efficiency Creation Potential</p> |

Under the *Broadcast Music* test, the rule of per se illegality is appropriate only for A; B must be handled by a rule of reason standard, while C and especially D should be treated as per se legal.

To apply this test to a factual situation, one must be able to recognize and distinguish between arrangements that are output restricting and those that are efficiency creating. Unfortunately, economists disagree about the economic characteristics of output restricting arrangements since such tell-tale signs as increasing market share and increasing market concentration may be a reflection of efficiency as well as output restriction.²⁴⁹ It is somewhat easier to describe the characteristics associated with efficiency creation.

Efficiency creating arrangements include those that: 1) integrate productive facilities or distributive efforts; 2) overcome an externality such as a free rider problem; 3) reduce transaction costs; or 4) overcome manufacturer/distributor incentive incompatibilities.²⁵⁰ The first example involves a coordination of productive or distributive efforts of firms

249. See 1983 *Antitrust Developments*, *supra* note 57, at 403-04. See also Hovenkamp, *supra* note 3, at 1305 n.56 & 1310-11. However, a number of situations and arrangements exist where a per se rule can be confidently applied. For example, where a restrictive intrabrand distribution system is used to reinforce a manufacturer cartel, the purpose of the arrangement is not to achieve any efficiencies, but to restrict interbrand competition. 1983 *Antitrust Developments*, *supra* note 57, at 404-05. The same can be said for a different type of dealer cartel than is discussed in this Article—an interbrand dealer cartel. See Baker, *supra* note 9, at 1489; 1983 *Antitrust Developments*, *supra* note 57, at 405-06. However, such a cartel involving the dealers of an entire product market, as opposed to intrabrand cartels which involve only the dealers of a single manufacturer, is rare. Finally, those intrabrand dealer cartels that do not involve the supplier can safely be placed in the per se category. According to Liebel, because these cartels are without supplier participation, it is unlikely they are created for efficiency reasons. See *supra* note 63.

250. The first three examples of efficiency effects are described in Gerhart, *supra* note 57, at 321-22, 334-44. For enlightened judicial discussions of the welfare implications of intrabrand restraints, see *Red Diamond Supply, Inc. v. Liquid Carbonic Corp.*, 637 F.2d 1001, 1004 n.4 (5th Cir.), *cert. denied*, 454 U.S. 827 (1981); *Copy-Data Sys., Inc. v. Toshiba Am., Inc.*, 663 F.2d 405, 410 (2d Cir. 1981), *cert. denied*, 474 U.S. 825 (1985).

which leads to a more efficient output. The efficiency creating integration that was involved in and described by the Court in *Broadcast Music* was that "of sales, monitoring, and enforcement against unauthorized copyright use."²⁵¹ The second example was specifically mentioned by the Supreme Court in its *Sylvania* decision.²⁵² Measures a manufacturer takes against free riding create efficiencies by preventing opportunistic behavior from disrupting its distribution system.²⁵³ The third example refers to any arrangement that reduces the costs of transacting business. It is related to the first example. To illustrate, the copyright license in *Broadcast Music* not only achieved an integration of legitimate market activities—example 1—but also reduced bargaining and negotiating costs which would be prohibitive if conducted on an individual basis.²⁵⁴ Finally, the fourth example refers to devices manufacturers employ to address the principal/agent problems that can arise with distributors or dealers.²⁵⁵

In addition to these specific examples, a more general inquiry can be made into the likely business *purpose* that an arrangement or restriction serves. If done correctly,²⁵⁶ such an inquiry can help us understand what

251. 441 U.S. at 20. See *Intrabrand Cartels*, *supra* note 9, at 17-18; *1983 Antitrust Developments*, *supra* note 57, at 400-02.

252. In *Sylvania*, the Court singled out the free rider effect and explained how nonprice restrictions could ameliorate this problem:

[N]ew manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products such as automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did.

Sylvania, 433 U.S. at 55. See also *Business Electronics v. Sharp Electronics Corp.*, 56 U.S.L.W. 4387, 4390-91 (U.S. May 3, 1988) (No. 85-1910); *Davis-Watkins Co. v. Service Merchandise*, 686 F.2d 1190, 1195 n.8, 1200 (6th Cir. 1982), *cert. denied*, 466 U.S. 931 (1984).

253. See *supra* notes 57 and 226.

254. As the *Broadcast Music* Court recognized, "[i]ndividual sales transactions in this industry are quite expensive, as would be individual monitoring and enforcement, especially in light of the resources of single composers." 441 U.S. at 20.

255. See *supra* note 8.

256. Both proponents and opponents of such an inquiry acknowledge that making such a determination is not easy. Compare Pitofsky, *supra* note 15, at 35 ("The primary problem with evidence of purpose—to put the matter bluntly—is that in modern antitrust cases, such evidence will often reflect what counsel advise businessmen their purpose should have been."), with *1983 Antitrust Developments*, *supra* note 57, at 421 n.180 ("Application of the *per se* rule or the rule of reason does not depend on the skill of some lawyer in making an arrangement

an arrangement's likely impact will be. For example, if the purpose of a territorial restriction is to increase sales, the likely effect of its imposition would be to enhance interbrand competition. Also, if the purpose of a restriction is to reduce transaction costs, to prevent opportunistic behavior or to induce resellers to provide more services or information, then the likely effect of the challenged arrangement is efficiency creating and thus procompetitive. In any case, where the likely effect of a challenged arrangement, restriction or practice is not readily apparent, courts should attempt to objectively determine its business purpose.²⁵⁷

An inquiry into the purpose of an arrangement helps determine what effect a restriction on intrabrand competition is likely to have. If it will likely increase interbrand competition *or* increase efficiency, then the per se rule cannot be applied under the *Broadcast Music* test. Likewise, if it will simultaneously produce anticompetitive and efficiency effects, the per se rule cannot govern.²⁵⁸ Perhaps at the next stage of inquiry—the rule of reason balancing test—such “potential” efficiency creating effects will prove to be ephemeral. Nevertheless, at the initial characterization stage, the court should be reluctant to condemn arrangements that *may* turn out to be welfare enhancing. Only if an arrangement has no potential to increase efficiency *and* will likely harm *interbrand* competition, is the per se rule appropriate.

E. The Analytical Framework Applied

The application of the framework described above can be illustrated by reexamining a case that was incorrectly decided. A number of cases reviewed in this Article were either wrongly decided or suffered from inadequate judicial analysis, and thus could serve as candidates for illustrative purposes. No case, however, serves as a more flagrant example of poor legal and economic reasoning than does *Guild Wineries v. J. Sosnick & Son*.²⁵⁹

Guild, it should be recalled, was a wine producer whose termination of an independent wholesaler was successfully challenged under a state

look ‘unique’ or ‘unfamiliar.’ It depends on whether the arrangement has the potential to increase efficiency or to restrict output. These factors cannot be manipulated by clever lawyers.”). However, Liebler does concede that it is impossible to distinguish between cartelization and efficiency enhancing purposes when dealers engage in cooperative activity. *Intrabrand Cartels*, *supra* note 9, at 5 n.18, 25 n.73, 26 n.76.

257. The inquiry should be objective, since subjective rationales by businessmen will often be inaccurate and self-serving.

258. 1983 *Antitrust Developments*, *supra* note 57, at 394-96.

259. 102 Cal. App. 3d 627, 162 Cal. Rptr. 87 (1980). See *supra* text accompanying notes 98-104 and 205-08 for a discussion of this case.

law patterned after the Sherman Act.²⁶⁰ Prior to 1975, Guild distributed its wines solely through independent wholesalers and assigned each of them an area of primary responsibility, a mild form of territorial restriction. Dissatisfied with its market share overall, and particularly in one geographic market—Fresno, California—Guild decided to take over some of the distribution functions itself. In 1975, Guild took over the wholesaling operation in the Fresno area. Shortly thereafter, one of Guild's independent distributors, Sosnick, began serving a large grocery chain in the Fresno area. When Sosnick refused to comply with Guild's demands to cease operating in Guild's territory, Sosnick was terminated as a distributor for Guild.²⁶¹

Fixated with the notion that Guild's entry into the wholesaling level transformed it into a horizontal competitor with its independent distributors, the majority in *Guild Wineries* held that the termination of Sosnick was illegal.²⁶² It ruled that Guild's efforts to enforce its territorial restrictions constituted a "horizontal restraint."²⁶³ The restraint was "horizontal" precisely because Guild was a dual distributor. In other words, a restraint that was "vertical" in 1974, magically became "horizontal" in 1975 when Guild decided to do some wholesaling of its own. Thus, the very same restraint took on a different character depending on what kind of supplier or who imposed it. Under the majority's reasoning, if the restraint was imposed by a supplier who did no distributing, it was regarded as "vertical." However, if the restraint was enforced by a supplier who also acted as a distributor, it was "horizontal." The court distinguished *Sylvania* because there the supplier, Sylvania, "did not compete with its distributors."²⁶⁴

Several facts, gleaned from the majority and dissenting opinions in *Guild Wineries*, raise concerns about the decision. First, Guild entered into the distribution field because it was alarmed by its overall low market share. In particular, Guild "wanted to increase its sales in the Fresno area."²⁶⁵ Second, Guild's executives testified that presale promotional services were important to the commercial success of its wine line.

260. The *Guild Wineries* court noted that federal law interpreting the Sherman Act was applicable to the Cartwright Act. 102 Cal. App. 3d 627, 633, 162 Cal. Rptr. 87, 90 (1980).

261. The case originally took the form of a breach of contract dispute. Guild brought action against Sosnick to recover monies due for liquor which Guild had sold to Sosnick. The antitrust issue which dominated the case arose when Sosnick filed a cross-complaint alleging violations of California's antitrust statute and seeking treble damages.

262. 102 Cal. App. 3d at 633, 162 Cal. Rptr. at 91.

263. *Id.*

264. *Id.* at 635, 162 Cal. Rptr. at 91.

265. *Id.* at 631, 162 Cal. Rptr. at 89.

Third, Guild's distribution system was plagued by inadequate performance of this service function and by free riding. Fourth, one of the free riders apparently was Sosnick who according to Guild "consistently refused to deliver promotional presale services to retail outlets"²⁶⁶ Of course, these "facts" may have proved false on further examination. Nevertheless, they may reveal a possible reason for Guild's actions, and provide clues to the possible effects of Guild's distributional arrangement. With these facts in mind, an analysis of Guild's arrangement is now possible.

1. Entry by Guild into the distributional level

Entry by a manufacturer into the distributional level is a form of vertical integration because the manufacturer extends his activity to a different level of the chain of distribution.²⁶⁷ Such integration does not harm interbrand competition and may be efficiency enhancing. Whether a manufacturer distributes entirely by itself, or employs independent firms for this function, or uses some combination of these two alternatives should not raise antitrust concerns. Further, consumer welfare is promoted by granting suppliers freedom to choose the arrangement that is most suitable to their circumstances. No reason exists to believe that only one type of arrangement is optimal for all firms. In *Guild Wineries*, no evidence indicated that Guild's entry into the distributional level was for an anticompetitive purpose, such as to collude with fellow wine *producers*. Therefore, the fact that it became a dual distributor should not by itself adversely affect the court's decision.

2. Guild's territorial restrictions

Applying the *Broadcast Music* test, the first question is whether the challenged arrangement has an efficiency creating potential. If it does not, the next question is whether the arrangement would adversely affect competition. Only if the answer to the first question is "no" and the answer to the second is "yes" may the *per se* rule be applied with confidence.

Here, no need exists to consider the second question. Guild's arrangement and accompanying restrictions were *potentially* efficiency enhancing. They were designed to encourage distributors to provide an array of presale services that presumably would increase the value of Guild's wine products to consumers—i.e., to provide consumers with the

266. *Id.* at 639, 162 Cal. Rptr. at 94 (Christian, J., dissenting).

267. That is, the manufacturer now performs a function—at a different level of the market—that was previously performed by an independent firm. See *supra* note 1.

price/quality or price/service mix they preferred. They were also designed to prevent free riding by opportunistic distributors who did not provide such services and to align distributors' incentives with those of the supplier. In short, both the arrangement as well as the termination of Sosnick were consistent with the promotion of efficiency. "Removal of free riders from the distribution system is the type of efficiency which the Supreme Court approved in *Sylvania*; terminations achieving that end should not be subjected to the *per se* rule."²⁶⁸

Assuming, however, that no efficiency creating potential was present, under the second test—i.e., whether the challenged practice adversely affects competition—the *per se* rule would be inappropriate because it was not demonstrated that the arrangement would harm interbrand competition. Indeed, its very purpose was consistent with an effort to expand sales rather than to restrict them. The testimony Guild's executives provided regarding the purpose behind the arrangement need not be accepted at face value. It is enough at the characterization stage to note that the arrangement is consistent with the procompetitive business purpose of *increasing* sales.

Clearly, under these guidelines, *Guild Wineries* was wrongly decided. The testimony by Guild's executives was arguably self-serving and some collusive scheme may have been secretly planned. If so, its discovery and resolution should be made at the rule of reason inquiry. Unfortunately, the formalistic approach the majority adopted in *Guild Wineries* precluded the initiation of such an inquiry. Under an economically oriented approach which looks to the likely effects of an arrangement, no justification exists for treating an arrangement like Guild's as one that would always, or almost always, restrict interbrand competition. The arrangement is consistent with an efficiency enhancing rationale and should not be condemned at the characterization stage. Moreover, as the analysis just described illustrates, no need exists even to address the perplexing question as to whether the arrangement was horizontal or vertical. Instead, the focus should be on whether such an arrangement harms or enhances consumer welfare.

VIII. CONCLUSION

Dual distribution is a perfectly legal method of marketing. However, when combined with other practices that limit the freedom of independent distributors or threaten their ability to compete, legal problems arise. Courts resolve such problems today in basically the same

268. 1983 *Antitrust Developments*, *supra* note 57, at 413 (footnote omitted).

manner as they have for decades—by engaging in an analytical process known as the “characterization process” which focuses primarily on the form such practices take. In legal controversies surrounding dual distribution, the outcome of the characterization process is often crucial to the ultimate resolution of the matter. Yet the characterization process has been subject to changing and often arbitrary judicial views, leading to inconsistent decisions. This Article has argued that the law of dual distribution is flawed because of the courts’ failure to follow the call of *Sylvania*²⁶⁹ to base decisions on economic effect rather than on formalistic line drawing. This flaw is particularly troublesome because “antitrust law is concerned not with superficial technical appearances, but with practical economic substance.”²⁷⁰

The analysis in dual distribution decisions also suffers from the inability of courts to analyze the practice of dual distribution separately from the vertical restraints which are often at issue. Since dual distribution by itself is perfectly legal, its presence theoretically adds nothing to the analysis and, therefore, should be disregarded. In practice, because dual distribution superficially resembles a horizontal arrangement, it is often taken into account in a negative vein. Because some courts view the presence of dual distribution with skepticism, their perception of the vertical restraints being challenged is colored. Dual distribution, in other words, “infects” nonprice restraints in the eyes of many courts.

By contrast, an economic approach views dual distribution as partial vertical integration which firms often employ to reduce costs or increase efficiency. If total vertical integration is not anticompetitive, its partial form should not be anticompetitive.²⁷¹ In the real world, however, dual distribution is often accompanied by vertical behavior that is subject to challenge. Under an economic approach such vertical restraints should be analyzed and legally rise or fall on their own. If verti-

269. 433 U.S. 36 (1977).

270. *Abadir v. First Miss. Corp.*, 651 F.2d 422, 427 (5th Cir. 1981).

271. Under certain limited circumstances, dual distribution as well as vertical integration can be used to facilitate collusion. In such cases, however, the problem is not the presence of dual distribution or vertical integration, but that of an underlying horizontal conspiracy. Indeed, dual distribution or vertical integration is merely a symptom of the underlying problem. For discussions that take a more critical view of vertical restraints than this Article, see Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985); Comanor, *Vertical Territorial and Customer Restrictions: White Motor and its Aftermath*, 81 HARV. L. REV. 1419 (1968); Pitofsky, *supra* note 15; Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983); Steiner, *The Nature of Vertical Restraints*, 30 ANTITRUST BULL. 143 (1985); White, *Vertical Restraints in Antitrust Law: A Coherent Model*, 26 ANTITRUST BULL. 327 (1981). See also articles cited *supra* note 8.

cal restraints were analyzed independently, the current anti-dual distribution bias would disappear.

The main problem in dual distribution cases centers on the failure of most courts to engage in *any* kind of economic analysis. Moreover, when courts do consider economic factors, their analysis is usually incomplete or fails to adequately evaluate a challenged practice in terms of its impact on consumer welfare. Instead of focusing on potential output and efficiency effects, most courts look only to the form of the arrangement or the source of any restrictions. Their analysis is based *solely* on the use of inadequate or incomplete proxies—vertical and horizontal²⁷²—and proxies of proxies—source of restriction, supplier or distributor—to the exclusion of other relevant economic factors, such as effects on price and output.²⁷³ The trouble with this approach is that it “involves the common error of focusing on the label rather than the reason for labeling.”²⁷⁴

Some progress, however, has been made during the decade following the *Sylvania* decision. While no opinion to date fulfills the standard originally called for by *Sylvania*, the three opinions highlighted in Section VI come close. The common thread linking Justices Harlan’s and Chris-

272. See, e.g., the FTC’s opinion in the *Coca-Cola* case where the commission defined its role in the characterization process as that of determining whether the restraints were horizontal or vertical. “Under the court’s most recent pronouncement [*GTE Sylvania*], then, the first step in evaluating these restraints is to classify them as horizontal or vertical.” 91 F.T.C. at 610-11.

It is ironic that an agency with economic expertise would interpret *Sylvania*’s call for an economic effects test in such a standard, formalistic manner. But that is how most tribunals continue to handle distributional restraint issues in the aftermath of *Sylvania*. Perhaps history would have been changed had the commission instead stated something like this: “Under the Court’s most recent pronouncement, we must first evaluate these restraints on the basis of their potential effects in economic terms in order to determine whether they should be governed by the rule of reason or the *per se* standard.” Or the statement could have been worded in terms of the *Broadcast Music* standard or in terms of Professor Liebler’s suggestion, *infra* note 273.

273. Liebler argues that courts should focus more directly on economic considerations.

If the Court would clarify the scope of the *per se* rule and the rule of reason in horizontal (interbrand) cases, the distinction between vertical and horizontal would not be nearly so important. The basic question in each case should be whether the arrangement can contribute to the restriction of output and whether it has an efficiency creating potential.

Intrabrand Cartels, *supra* note 9, at 4 n.12.

274. Baker, *supra* note 9, at 1510. This problem is not restricted solely to dual distribution. Unfortunately, antitrust decisions—more so than other legal areas—often tend not to focus on the real problem. This is especially so where extraneous factors are involved, such as the presence of dual distribution. Real antitrust problems, according to economic and consumer welfare theory, are arrangements that lead to output restriction, collusion, or otherwise adversely affect interbrand competition. Alarm bells should not go off simply because an arrangement looks horizontal or because a restriction originated at the dealer level. One cannot be confident that an arrangement or restriction is *per se* illegal without first examining its likely economic effect.

tian's dissents, with the Ninth Circuit's opinion in *Krehl v. Baskin-Robbins Ice Cream Co.*²⁷⁵ is their reliance on economic factors for characterizing restraints and their focus on interbrand competition. Rather than distinguishing between different forms of business arrangements (vertical or horizontal) or the source of restrictions (manufacturer, distributors or retailers), these opinions focus on whether restrictions merely affect competition between different resellers of the same brand (intrabrand) or whether they affect resellers of all brands (interbrand). The analytical approach in these opinions is basically correct since the relevant competition under *Sylvania* is interbrand. Restrictions that directly affect only intrabrand competition, in other words, should be analyzed under the rule of reason no matter what their source. Apparently, this is the direction the courts are headed when confronted with restrictions imposed by dual distributors. The momentum could be accelerated if courts would tailor their analyses along the lines suggested in the previous section, or at a minimum, would adopt the criteria the Court set forth in *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*²⁷⁶ Continued failure to take these minimal steps will mean that manufacturers who use dual distribution arrangements will do so at their peril and that luck, rather than reason, will continue to determine the legal outcome of challenged arrangements.

275. 664 F.2d 1348 (9th Cir. 1982).

276. 441 U.S. 1 (1979).